IT Services

First law of thermodynamics – QED!

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INDIA | IT SERVICES | Sector Update

The first law of thermodynamics, more popularly known as law of conservation of energy, is also stated as 'Perpetual motion machine of the first kind (PMMFK) is not possible'. PMMFK, in non-engineering parlance, is a machine that produces work without input of energy; since it violates the first law, it cannot exist. We see the Indian IT services sector as another manifestation of the law – there cannot be growth without investments, which the sector has failed to make over the last decade.

Read this report for:

- How the last decade turned out to be the 'lost decade' for Indian IT companies
- How the Indian IT companies are getting sandwiched between large global consultants and small niche companies
- Our downgrade of the IT sector, based on them failing to capitalize the early stage of the digital transformation wave

The last decade or the 'lost decade'

The Indian IT services industry had a lot going for it in the last decade - right from new geographies opening up to outsourcing to an abundant pool of engineers. Aided by 36% USD-INR depreciation **in the last 10 years, Indian IT companies (top-4) saw 21% CAGR and generated cumulative cash of Rs 2.1tn.**

However, instead of utilizing the cash to build/acquire delivery capabilities for the future (in the digital space), **IT companies distributed 42% of cash as dividends, invested 24% as capex, and let 34% sit idle as cash/investments. They spent only 12% on acquisitions.** At the same time, Cognizant spent 45% of the cash on acquisitions. While the companies claim to have developed in-house capabilities, we believe it has not led to high level of confidence in their delivery capabilities in the digital space.

The result is that Indian IT companies have (or are perceived to have) significantly inferior capabilities in the digital space. This lost opportunity – of investing the mammoth cash generated in the last decade into building/acquiring capabilities for future – will cause IT companies to be laggards in the digital transformation cycle.

Sandwiched between two layers

Our interaction with industry experts and consultants suggests that **global consultants like McK, Deloitte and Accenture are currently capturing a larger share of the digital transformation cycle.** Concurrently, **hardware providers like AWS and MS-Azure are stepping up and cannibalizing the traditional revenue streams like IMS**. Since most companies are clueless about the possibilities of digital platform, they have postponed their traditional IT modernisation plans also, to await the outcome of adoption by market leaders.

Indian IT companies are also losing out to small niche companies, based out of Silicon Valley or similar hubs across the world. These companies, (like Mu Sigma), significantly smaller in size, offer expertise in specific domains (analytics, mobility, cloud) and are being enquired about more frequently even if they may not be clinching most of the deals – yet!

We believe that Indian IT companies, sandwiched between these two layers, will find it extremely difficult to find their niche in the digital space.

Consensus still not factoring in the deceleration, de-rating imminent

Consensus estimates for FY17 predict mid-teen growth for all companies (top-5, excluding Wipro) even as none will report double-digit growth even in FY16. We expect consensus estimates to be revised downwards. Since we do not see most Indian IT companies reporting double-digit growth over the next 2-3 years, we expect the entire sector to be de-rated (excluding a few names such as Infosys and Mindtree).

We have downgraded our multiple for the entire IT sector on expected deceleration in growth over the next two years. We downgrade TCS and HCL Tech to Neutral, and Wipro and TechM to SELL. We maintain BUY on Infosys and Mindtree.

Downgrade Sector to UW

Companies

TCS	**(Downgrade)**
CMP	2445
Rating	NEUTRAL
TP	2550
Infosys	**(Maintain)**
CMP	1100
Rating	BUY
TP	1270
HCL Tech	**(Downgrade)**
CMP	855
Rating	NEUTRAL
TP	900
Wipro	**(Downgrade)**
CMP	557
Rating	SELL
TP	490
Tech Mahindra	**(Downgrade)**
CMP	522
Rating	SELL
TP	420
Mindtree	**(Maintain)**
CMP	1480
Rating	BUY
TP	1625
NIIT Technologies	**(Maintain)**
CMP	586
Rating	BUY
TP	650
KPIT Technologies	**(Downgrade)**
CMP	170
Rating	SELL
TP	140
Persistent Systems	**(Downgrade)**
CMP	665
Rating	SELL
TP	530

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Companies

The last decade or the lost decade

Over the last four quarters, almost all top Indian IT companies have reported lower than expected revenue growth in organic terms. While cross currency impact has played its part, CC growth too has been rather muted. The average rolling annualized USD revenue growth for the top-4 in the last four quarters has been a muted 7.8%. While this might be anecdotal evidence of the present and forthcoming slowdown in the IT Services sector, the real reason we believe, is rooted deep in the past. We dare to call the last decade a 'lost decade' for the Indian IT services industry.

Everything going its way in the last decade

The Indian IT services industry had a lot going for it in the last decade. Developments, both micro and macro, led to an unprecedented growth for the entire industry and significant cash accrual.

1) **USD-INR tailwind:** Over the last decade, USD-INR depreciated by 36%, providing a significant boost to the margins of the Indian IT companies. Accordingly, the operating margins for TCS/HCL/Wipro expanded 117/301/35bps over the last decade.
2) **Indian IT companies gaining market share from global counterparts:** Over the last decade, companies such as TCS, Infosys, and HCL Tech grabbed large amount of market share from global counterparts such as IBM, Cap Gemini, and Atos Origin. While part of this success was attributable to USD-INR depreciation, which made their pricing more competitive, there was also a remarkable enhancement of customer confidence in the delivery capabilities of Indian IT companies. All this was borne out of the hard work and investments by the industry in the preceding decade.
3) **The supply advantage:** The number of engineering graduating every year in India has grown by 284% over the last decade. While the country produced 0.38mn engineers in 2006, today it produces 1.45mn. This surge in the supply of engineers meant that IT companies have abundant resources available to them, without having to worry about the cost. Little surprise that TCS, the market leader in setting industry salaries, did not raise its fresher-level salaries for the last seven years.

These tailwinds meant that the entire sector had windfall gains in the last decade. Top-4 companies reported 21% CAGR in topline, 21% CAGR in earnings, and their market cap grew by 3.8x over the last decade. The growth also meant that the top-4 Indian IT companies generated cumulative OCF of Rs 2.1tn over the last 10 years.

Top-4 reported robust cashflows over the last decade

Rs mn	TCS	Infosys	Wipro	HCL Tech	Total
Revenue	53,41,604	28,95,800	28,87,561	17,38,637	1,28,63,602
PAT	11,78,821	7,04,165	4,97,271	2,68,524	26,48,782
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
	TCS	**Infosys**	**Wipro**	**HCL Tech**	**Total**
PAT Margin	22.1%	24.3%	17.2%	15.4%	20.6%
OCF/PAT	73.5%	82.6%	87.4%	100.2%	81.2%
FCF/PAT	58.7%	59.9%	65.2%	74.5%	61.8%

Source: Company, PhillipCapital India Research

But where did all the generated cash go?

The problem lies with the utilization of the cash that these companies generated in the last decade. While their success in the last decade has to be attributed to the investments they made in the preceding decade, it should have been clear to the industry that their investments in the current decade would decide their growth in the next. However, almost all Indian IT companies assumed that status quo will prevail and made negligible investments in building/acquiring delivery capabilities for the future.

Over the last decade, the top-4 Indian IT companies generated Rs 2.1trn of cash (OCF). As we analyse the utilization of this cash, we find:

1) 42% of the cash was paid back to investors as dividends
2) 24% was invested as capex – building, machinery etc
3) 34% is lying as cash/investments.

Over the last decade, top-4 companies, together, spent only Rs 190bn (12% of the total cash generated) on acquisitions. Even in that, 59% of the total acquisitions (by value) were done by two companies – HCL and Wipro.

Also, over the same period, while companies such as TCS and HCL significantly increased their S&M (as % of sales), cumulative spend on S&M remained broadly the same over the last 10 years.

Utilization 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: Company, PhillipCapital India Research

So, in a nutshell, in a decade where the Indian IT industry had almost everything going for it – from currency benefit to waning competition – the players did the following to secure their future growth:

1) Passed on the entire benefit of rupee depreciation, to customers or to margins
2) Passed on 42% of the cash they generated as dividends to the investors, with another 34% lying idle
3) Invested only 12% of the cash generated in acquiring capabilities, even when they had a radical industry transformation (digital) staring them in the face.

At the same time, Cognizant went on a shopping spree

While Indian IT firms remained inert, Cognizant did the exact opposite by investing in acquiring/building capabilities. Over the last decade, Cognizant Technologies (CTSH) generated US$ 7.4bn of cash and spend US$ 3.3bn on acquisitions (45%). While Accenture (ACN) spent only US$ 2.9bn (9%) of US$ 33bn cash it generated, its digital business is driven by its consulting practice in any case.

CTSH and CAN have utilized the cash in much better manner

US$ mn	CTSH	Accenture
Revenue	46,821	2,45,839
PAT	6,886	21,387
OCF	7,408	32,934
FCF	5,593	29,688
Dividend/Buyback	761	24,125
Capex	1,815	3,246
Cash & Investments	3,127	1,877
Acquisition	3,313	2,885
Dividend/Buyback as% of OCF	10.3%	73.3%
Cash & Investments as % of OCF	42.2%	5.7%
Acquisitions as % of OCF	44.7%	8.8%

Source: Company, PhillipCapital India Research

The results are there for all to see. CTSH and ACN are now 'perceived' to have much superior delivery capabilities in the digital space and are growing at a much higher pace than the top-4 Indian IT companies. Even in CY16, CTSH and ACN are expected to report USD revenue growth of 20% and 8% respectively – significantly ahead of the top-4.

What if the top-4 were investing in building in-house delivery capabilities

The often-cited justification by leading Indian IT companies for their poor acquisition track record is that they have been investing in building in-house delivery capabilities. They even claim to have an early mover advantage in the digital space by virtue of identifying the space and investing in it much earlier than others.

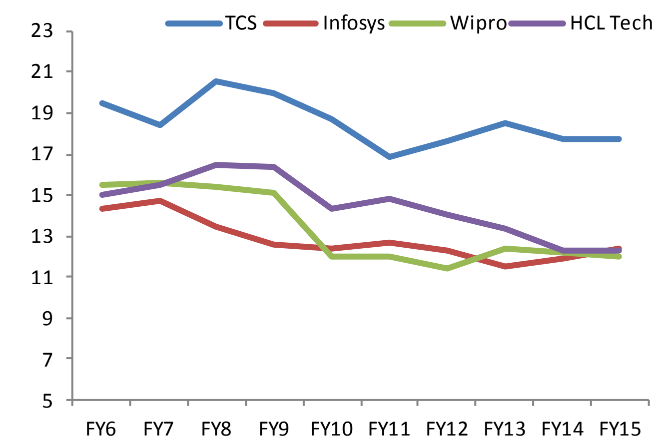
The problem, we believe, lies not in the actual delivery capabilities, but in the 'perception' of those abilities. We have long maintained that there is virtually no difference in the delivery capabilities of Indian IT companies (even the smallest ones) and global giants (even the biggest ones). All these companies hire most of their engineers from India, provide them with similar training, and have comparable salary levels.

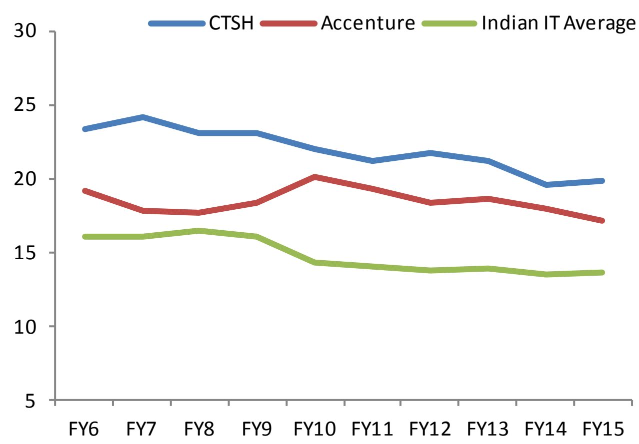
What matters, in our opinion, is the 'perception' of their delivery capabilities. It took Indian IT companies more than two decades to penetrate the European region, primarily because of lack of confidence in their delivery capabilities. Indian IT companies were as capable as Cap-Gemini and Atos-Origin, but it took successful execution of projects at multiple fortune 500 clients for European companies to gain confidence in them.

We see a similar story being played out in the digital transformation space. Indian IT companies are considered more 'IT modernization' vendors and not really the 'Digital Transformation' people. While companies have won multiple deals in the digital transformation space, their number and size are highly insignificant compared to the overall market size.

Also, if we look at the financials of the last decade of the top-4, we see that S&M as % of sales hasn't really moved up. While it has definitely improved for TCS and HCL, it remained stagnant or declined for others. So while the companies "might" have been investing in building in-house delivery capabilities in the digital space, they were surely not spending more on apprising clients about these new capabilities. Problem of perception again.

S&M as % of Sales – CTSH and ACN have been consistently spending more than the top-4





Source: Company, PhillipCapital India Research

If we compare the number of IPs that Indian IT companies have filed, with non-Indian ones – the contrast is stark. While the TCS and Infosys (for whom data was available) have filed for 2809 IPs over the last five years, Accenture alone has filed for 5000 and Cognizant 624.

IP filled by global majors

	Infosys	TCS	Accenture	CTSH
Filled	532	2,277	5,000	624
Granted	87	206	2,600	NA

Source: Company, PhillipCapital India Research

Making amends now, but is too late

Over the last two years, the Indian IT companies have realized the need to acquire companies with existing or perceived delivery capabilities in the digital transformation space. While their number and size is still quite small, we see it as positive development. The only concern being – has it come too late in the day?

Acquisitions by Indian companies

Company	Acquisitions in Traditional Space	Acquisitions in Digital Space
Infosys	Lodestone	Skava, Panaya, Noah Consulting
TCS	Alti, Neotel	
Wipro	Cellent, SAIC	DriveStream
HCL Tech	Axon	
Mindtree	Aztecsoft	Discoverture Solutions LLC, Bluefin Solutions, Relational Solutions
TechM	Satyam, Comviva, BASF, LCC, Softgen,	

Source: Company, PhillipCapital India Research

Sandwiched between two layers

While the digital stream currently forms less than 10% of the revenue profile of Indian IT companies (top-4), its share has been constantly increasing. Accenture already reports that over 40% of its revenue comes from the digital space. Over the next decade, digital (including cloud, mobility, analytics and social) is expected to be a US$ 1trn market in 2020, gradually substituting the entire existing IT infrastructure at enterprise and individual levels.

Not only is digital changing the entire landscape of multiples industries, it is also disrupting the way companies conduct their business and interact with their customers. All companies, across verticals, are now asking this question to their IT vendor – what can we do in the digital space?

Our interaction with leading industry experts, on the digital landscape, reveals the following:

1) **Presently, 'consultants' are capturing the larger pie in the digital space:** Most of the companies do not know what they can do in the digital space – so they appoint a consultant (McKinsey, Deloitte, Accenture) to devise their digital-transformation strategy. The developer, in most cases, is selected by the consultant, and if the consultant has delivery capabilities (e.g. Accenture), the development contract also goes its way. Accenture has, by far, been the biggest beneficiary of this digital-transformation cycle.
2) **In a competitive industry, only top-3 players spend on digital transformation:** Market leaders are deploying digital practices to retain market-leading positions. Number 2/3 players are investing to capture market share from the leader. However, the remaining players in almost every industry are currently sitting on the fence – waiting to see the results of the adoption of digital practices by the market leaders, to decide their own course. This has led to postponement of significant amount of digital spend, which was expected in the next few years.
3) **Niche companies with breakthrough technologies are enquired about very frequently, even if they may not end up winning contracts:** Names of small niche companies operating out of silicon valley (e.g. Flutura, Zentera and Apaku) or for that matter, Bengaluru (e.g. Mu Sigma, CtrlS and nuVizz) crop up at most digital-transformation deals even if they are not invited for the RFPs for most.
4) **Hardware companies such as Amazon, IBM, and MS are boosting their software development capabilities and offering packaged deals:** Companies such as Amazon, IBM, and Microsoft (with cloud platforms AWS and Azure) have significantly expanded their application development teams and are now offering package deals to enterprises. These hardware providers are now offering migration support to the new cloud system under a package deal that is cannibalizing the traditional revenues of IT Services companies.

Indian IT companies appear to be sandwiched between layers of large consultants/hardware companies and small niche companies in the digital space on the other. While the big guys are using their relationships and larger platforms as an advantage, the small niche companies are using their x-factor to steal the thunder.

Amazon Web Server (AWS) – stepping it up

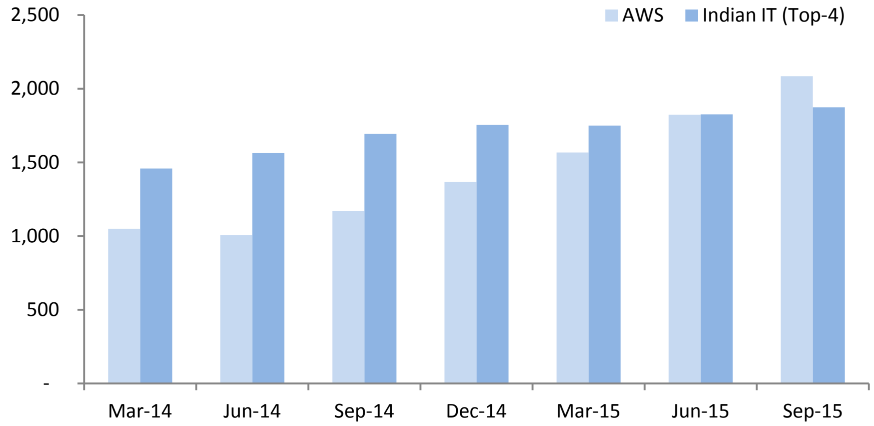
Amazon has raised the competitive intensity in the IT space in the last few quarters. Its Infrastructure-as-a-Service platform AWS, has been highly aggressive – offering platform for third party application development and cloud migration support. Offering database, server and computational capacity on-the-go, AWS has already marched ahead of combined IMS revenues of the top-4 Indian IT companies.

Application offerings by AWS

Compute	Storage and Content Delivery	Database	Networking
Virtual Servers	Object Storage	Relational	Virtual Private Cloud
Containers	CDN	Database Migration	Direct Connections
1- Click Web App deployment	Block Storage	NoSQL	Load Balancing
Auto Scaling	File System Storage	Caching	DNS
Load Balancing	Archive Storage	Data Warehouse	
	Data Transport		
	Integrated Storage		

Source: Amazon, PhillipCapital India Research

AWS revenues have now overtaken Top-4 Indian IT IMS combined revenues



Source: Amazon, Companies, PhillipCapital India Research

Likewise, IBM offers its application development platform "Bluemix" – that provides access to an ocean of APIs, and allows users to build and run applications, hosted on the IBM Cloud. Microsoft also has a similar platform and is offering packaged deals for its cloud platform (Azure).

As if the competition from global consultants such as Accenture wasn't enough! Amazon and MS offering platform for application-development spells really bad news for Indian IT companies. For long, Indian IT companies have maintained that while cloud migration will cannibalise part of their IMS revenues, they will be able to mitigate these by helping their clients migrate to the new cloud platform and application development after migration. Packaged offerings from Amazon and MS mean that Indian companies will have to fight it out in that space too.

If this is an indication of things to come, it wouldn't be long before companies like IBM and MS, who also possess application development capabilities, start offering some basic enterprise applications (like CRM, ERP) as a package deal along with their cloud platform services. This possibility, in our opinion, poses the biggest threat to the growth of the Indian IT Services companies.

Special Section: Cloud benefit analysis by ISG

In June 2015, ISG published a report with a "Cloud Comparison Index", highlighting the benefits of migrating to a cloud platform – comparing the cost of a public IaaS (Infrastructure as a Service) with internal IT. While the benefits of using a cloud platform over internal IT system have been long documented, this was the first attempt by any organization to quantify the benefit.

For this analysis, ISG created a model of sample configuration that reflects one specific type of infrastructure used widely, typically for new application development/testing. It then found the cost for the same sample across four leading public cloud providers and costs that would be associated with a comparable internal IT configuration.

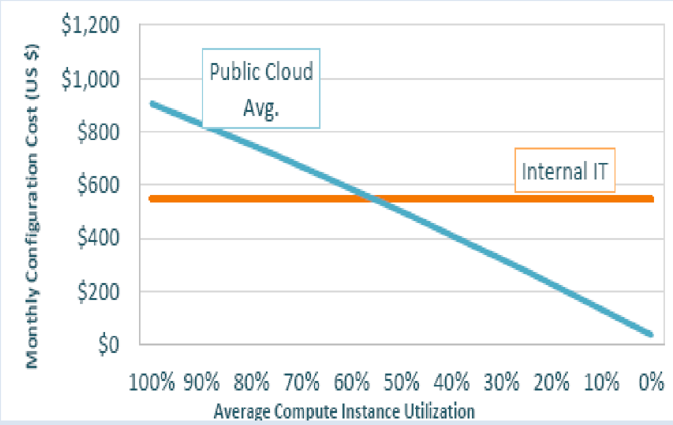
Item	Quantity	Specification
Application Servers	4x	2 cores, 16 GHz per core; 4 G RAM; 100 G local disk; Windows
Database Servers	2x	4 cores, 16 GHz per core; 8 G RAM; 100 G local disk; Windows
Storage	1x	1000 G NAS

Source: ISG

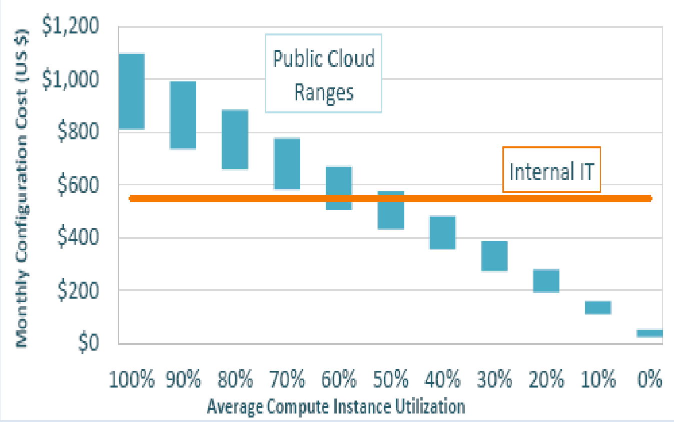
According to their analysis:

- An internal IT system is more economical as the 'instance utilization' rises. The breakeven point is 55% – above this internal IT systems are more economical and below it public IaaS leads to cost savings.
- At 100% utilization, internal IT costs are 32% lower than lowest priced IaaS.
- Comparing four leading public IaaS providers (Google Cloud, MS Azure, IBM SoftLayer and AWS) – the price spread between them is as high as 35%, at 100% instance utilization.

Average price of public cloud services vs. internal IT



Cloud price distribution by usage



Source: ISG Research

The report highlights that while using cloud platforms might not always be cheaper, at less than 55% instance utilization, it leads to significant cost savings. Few organization run at utilization levels of above 50% at all times. There might be instances where utilization rises to high levels, but those remain few and for short durations for all companies.

It is this cost saving, which is pushing more and more organizations, especially from the SME segment, to migrate to cloud platform. As technology evolves and competition intensifies, we see the benefits increasing incentivising more corporate to join the cloud platform bandwagon.

The 'young guys' stealing the zing

The other layer under which we see the Indian IT companies being sandwiched, is the small niche companies in the digital space. Nasscom says there are over 2000 start-ups in India that offer digital solutions to enterprise customers (overall 7000 companies) – ranging from mobility platforms to analytic tools. These companies are the 'talk of the town' and are often enquired about in any digital transformation deal even if they might not be invited to the final RFP – yet!

Below are few examples of US and India based starups, which currently offer digital enterprise solutions.

Niche Companies offering enterprise solutions – US Based

Analytics	Location	Cloud Computing	Location	Mobility	Location
Actian	Redwood	Zentera	San Jose	Apaku Inc	California
Birst	San Francisco	Cloud Spectator	Boston	Nativeflow	New York
BloomReach	Mountain View	Evolve IP	Wayne	nuVizz	Atlanta
Cirro	San Juan Capistrano	HireMojo	Larkspur	Mobile Labs	Atlanta
Flutura Solutions	San Jose	Netensity	Fremont		
Hadapt	Cambridge	Nimbix	Dallas		
Link Analytics	Atlanta	ProfitBricks	Cambridge		
WG Sigma Systems	San Jose	Virtustream	Bethesda		

Source: PhillipCapital India Research

Niche Companies offering enterprise solutions – India Based

Analytics	Location	Cloud Computing	Location	Mobility	Location
Crayon Data	Singapore	CtrlS Datacenters	Hyderabad	Brindley Technologies	Mumbai
Flutura	Bangalore	CipherCloud	Hyderabad	Click Labs	California, US
Axtria	New Jersey	Clearlogy Solution	Pune	Cnonymn Mobitech	Hyderabad
FlyTxt	Netherlands	iNube Software	Bangalore	Decimal Technologies	Gurgaon
Sapience Analytics	Pune	NxtGen Datacenter	Bangalore	NDOT Technologies	Coimbatore
SIBIA Analytics	Kolkata	A2Zapps	New Delhi	Nivaata Systems	Bangalore
Ideal Analytics	Kolkata	CliQr Technologies	Bangalore		
Formcept	Bangalore				

Source: PhillipCapital India Research

We see this layer as a significant challenge to Indian IT companies. The small size and niche focus of these companies provides them a significant advantage over the larger and more diversified Indian IT companies. Their focus on individual domains (mobility, cloud, analytics) also give them 'specialists' status, which makes them preferred vendors if the focus of the client is on the specific field that they specialise in.

While we believe that in this early adoption stage of digital transformation, only few vendors will dominate, if vendor diversification starts, these start-ups will prove significant competition to Indian IT companies.

Special section – Case study – Mu Sigma

Mu Sigma is an analytics firm that helps companies 'institutionalize data driven decision making and harness Big Data'. Founded by Dhiraj Chidambaram Rajaram in 2004, it specializes in marketing, supply chain, and risk analytics. In 2005, Microsoft became its first client when it started a pilot project to understand consumer behaviour.

Over the last decade, the company has reported spectacular growth, adding some of the biggest companies in the world as its client, including Wal-Mart and Dell. Today it caters to more than 140 Fortune 500 clients. In FY15, the company has clocked revenues of over US$ 200mn with PAT margins of ~50%. The company currently employs more than 3500 'data science professionals'.

The model that Mu Sigma deploys is quite unique. Unlike other traditional IT services deals, where the scope of problem is clearly defined – ***Mu Sigma signs an annual contract with its clients, wherein it will try to solve ALL the problems that it faces (under the defined scope) using data analytics.*** The company has seldom lost any client, and has achieved remarkable success in cross-selling and up-selling its services to other division in the same enterprise.

Mu Sigma provides data analytics services to its clients across the world, through an ecosystem of proprietary technology platforms, processes, and people. The firm has a three-pronged strategy to address clients' needs:

- **Data Engineering** – application of technology for collecting, storing, processing, transforming and structuring of data.
- **Data Sciences** – application of math and technology to solve focused business problems with well-defined scopes.
- **Decision Sciences** – an interdisciplinary approach of business, applied math, technology, design thinking and behavioural sciences, to solve constantly shifting and ill-defined business problems.

Solution framework followed by Mu Sigma

Decision Support Stack	Applications	Platforms
DECISION SCIENCES	Structured Problem Solving and Guided Analytics Workbench Decision Support Applications Analytics Operationalization Systems Intelligent Systems	muLearn muESP™ muMix™ muPDNA™ muRx™ muFusion™
DATA SCIENCES	Applied Math Algorithms Econometrics Machine Learning Natural Language Processing (NLP) Operational Research Artificial Intelligence	muXo™ muHPC™ muText™
DATA ENGINEERING	Data Acquisition (Data at Rest, Data at Motion) Data Storage (Databases, Big Data, In-memory) Data Processing (ETL, Event Processing) Data Workflow Management Computation Enablement Systems	

Source: Mu Sigma, Phillip Capital India Research

Mu Sigma has benefitted immensely from its positioning as 'problem solver' rather than software engineers. ***From its inception, the company has targeted only Fortune-500 clients, and not any enterprise outside that bracket.*** The company charges a premium for its specialization in its the domain – ***its billing rates are 2-3x the rates quoted by traditional IT services companies.*** The companies bills its customers on 'people-platform-processes' – wherein it charges a license fees to the client for using its platform and processes, while the billing for people is done on T&M basis.

Mu Sigma is the perfect example of a company being at the right place, at the right time. The company was born in the internet age – so it was crucially aware of the oceans of data present in the ecosystem. Surge of social platforms such as Facebook and birth of smartphone devices have led to assimilation of exabytes of data in the hands of these companies. All these companies want to study, analyse, and use this data, to understand their customer behaviour or optimize operations. Mu Sigma, with its hosts of proprietary platforms and data scientists, offers to do just that for them.

The company has had a phenomenal run since its inception – topline of US$ 200mn in eleven years since inception and remaining profitable since its second year. ***Over the last three years, it has grown by a CAGR of over 40% and its size today is almost 10x its closest Indian competitor in the pure-analytics space.*** It currently employs over 3500 'data science professionals' – looking to add another 1000-1500 this year. ***Over this period, it secured funding from FTV Capital, Sequoia, General Atlantic, and MasterCard, and attained US$ 1.5bn valuation in 2013.***

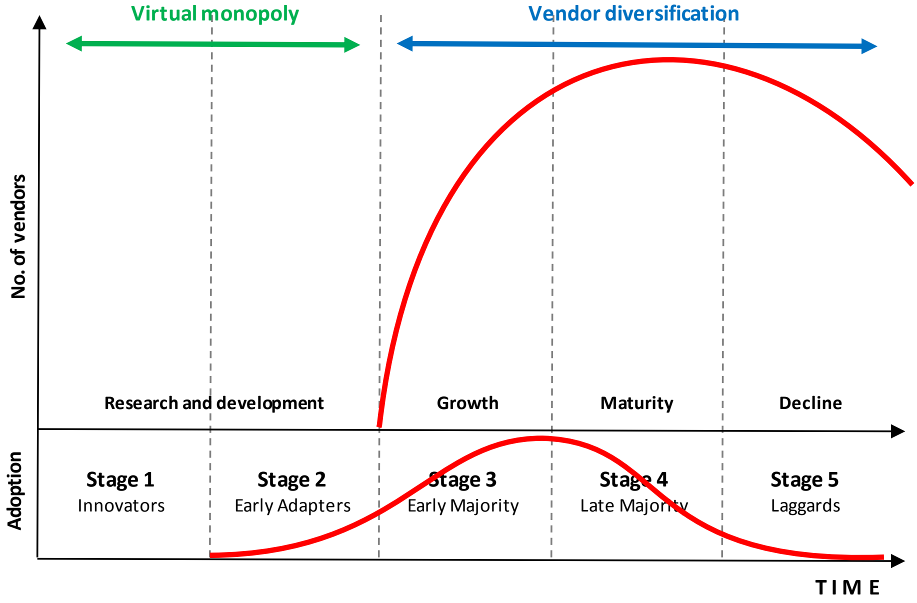
However, Mu Sigma has been facing a significant challenge in terms of attrition, which remains as high as 25%. While the company provides extensive training of 4-6 months to the 'freshers' it hires from various disciplines (engineering, statistics, mathematics, graduates), the huge number of start-ups in the analytics space has meant that employees have been quick to jump ship. To arrest this exodus, the company recently raised its salary levels to Rs 2.1mn (three-year period) from the earlier Rs 1.8mn – much higher than the salaries offered by traditional IT services companies.

The threat that Mu Sigma and a host of other similar companies pose to traditional Indian IT services companies is immense. Data analytics, though small in size currently (when compared to size of overall IT industry), has huge potential to grow. Mu Sigma has carved a niche for itself in this domain and with 140 of the Fortune 500 clients under its belt, it poses a big challenge to IT services companies who are trying to jump onto the analytics bandwagon.

Vendor diversification unlikely to come in soon

With digital being a relatively new space, we expect clients to tread carefully. In the 'early adapters' phase of any technological disruption, vendor monopoly is virtually a given thing. Enterprises do not want to spread themselves across multiple vendors in a relatively new technological domain. Hence, we see consultants (like Accenture) and hardware providers (like Amazon and MS) having a significant competitive edge over Indian IT companies in the digital transformation cycle – at least in the early adapters phase.

Vendor diversification typically clicks in later stage of technology adoption cycle

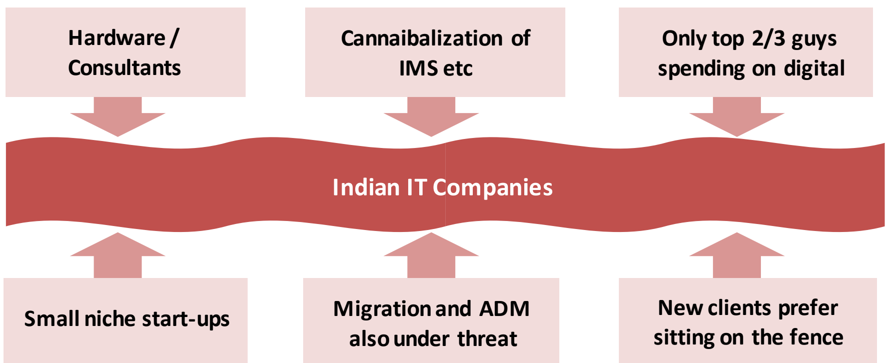


Source: PhillipCapital India Research

So we see the Indian IT companies being cornered from all the sides:

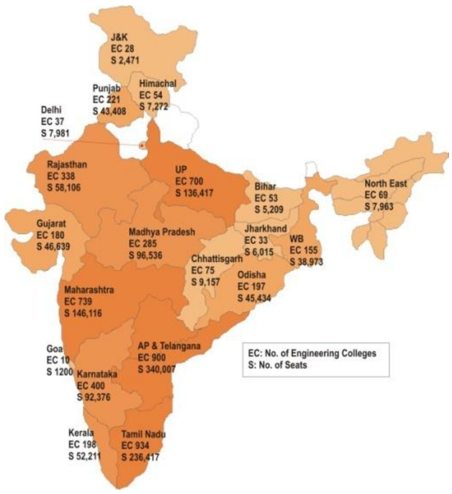
1) On one end are the large global consultancy firms and on the other there are small niche start-ups from Silicon Valley
2) While cloud migration is significantly cannibalizing the revenues of the IMS segment, service lines like ADM and digital migration are also under threat from the package deals provided by global hardware providers
3) Only the top 2/3 players in every vertical are spending on digital transformation and they prefer to go with the global vendors (at least as of now). On the other hand, smaller players are sitting on the fence, postponing their otherwise required system upgrade also.
4) Early adoption stage of the digital cycle means few vendors will dominate. Later, even if there is vendor diversification, the start-ups will pose significant competition.

Indian IT services companies – sandwiched from all sides



Supply side issues – for the first time

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



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

The country saw a surge in the engineers' output over the last decade

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Graduate Output	323,600	372,400	392,400	451,700	498,082	622,603	812,679	1,042,800	1,174,634	1,302,853
4 year engg degree	201,100	244,500	258,800	312,200	344,258	430,323	572,329	758,400	854,400	957,000
3 year engg diploma	122,500	127,900	133,600	139,500	153,824	192,280	240,350	284,400	320,234	345,853
Post graduate output	54,400	61,500	61,800	62,400	72,777	87,332	104,799	115,200	133,096	147,147
MCA	40,800	47,300	47,000	46,700	54,466	65,359	78,431	-	-	-
Engineering post graduates	13,600	14,200	14,800	15,700	18,311	21,973	26,368	-	-	-
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**
Industry headcount (incl BPO)	1,293,000	1,621,000	1,962,000	2,196,000	2,300,000	2,541,000	2,774,573	3,041,000	3,267,000	3,519,000
Industry headcount (ex-BPO)	878,000	1,068,000	1,327,000	1,458,000	1,530,000	1,715,000	1,897,000	2,096,000	2,278,000	2,487,000
Net hiring	235,000	328,000	341,000	234,000	104,000	241,000	233,573	266,427	226,000	252,000
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

Over the last 5-6 years, many of global IT companies (MS, Google, IBM, Accenture and Cap Gemini) have opened their development centres in India and currently employ over 275,000 software engineers. These companies remain the preferred choice of employment for students, given their MNC background, slightly better salaries, and most importantly, potential opportunity to relocate to their development centres in the US/Europe.

Top MNC employers in the IT segment in India

Company	Employee Strength in India
Microsoft	6,500
Google	6,500
IBM	130,000
Accenture	80,000
Cap Gemini	50,000
Cognizant	73,100

Source: Companies, Media sources, PhillipCapital India Research

However, since supply still far outstripped the demand, Indian IT companies did not have to worry too much and maintained the salary levels.

Start-ups stealing the thunder

Come 2014-15, the scenario seems completely reversed. A slew of start-ups, financed by the world's leading private equity companies, have captured the entire IT landscape in India. Engineers, fresh out of college, are being encouraged by private equity companies to start a venture of their own. These ventures, with sound financial backing, are offering unprecedented salaries to fresh and experienced developers in the industry.

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

Comparative salaries of software engineers at start-ups

Company	Salary
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 the IT services companies is differentiation.

Most of these start-ups are working on the latest technology platforms – like Hadoop, iOS and Android. They are building applications/apps that capture the imagination of the crowd and offer exciting possibilities. Analytics platforms ask for developers to write code that separates noise from the data and 'analyses' the refined data. Mobility platforms offer a chance to create seamless integration across various devices. The potential and opportunities to explore, and develop in this domain are endless.

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 and are 'boring' to work on. Most 'engineers' work on CRM/ERP applications for BFSI/Manufacturing clients – where they are neither able to relate with the application nor the domain.

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

Also, for long, the *biggest* attraction to work in the Indian IT services industry was the onsite opportunity. However, with US and host of other countries looking to implement strict immigration laws, the onsite opportunities are expected to reduce significantly. Infosys has already capped the tenure of an onsite deputation for every employee at 12 months. Similar unofficial practices are followed at 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.

It's not just the quantity, but the quality too

Another challenge that IT services companies are facing on the supply front is the quality of employees. With digital transformation deals taking the forefront, the need for experienced developers with an understanding of various platforms/tools has shot up significantly. For example, analytics field requires people with mathematics/statistics background, which are not readily available in India, and surely not at the cost IT services companies are accustomed to paying. Dearth of such talent translates into a high premium for the employable pool, leading to distortion in the salary structure at these large organizations.

So is it curtains for Indian IT companies? Not at all

The above analysis suggests that the Indian IT companies are facing, and will continue to face, significant challenges from the supply as well demand side over the next few years. While on the demand side they are being sandwiched between the global MNCs and smaller niche companies, on the supply side they are struggling to find the quantity as well as the quality of engineers to be able to meet the demand.

However, we do not see this translating into a complete washout for Indian IT services companies and obsolesce of their business models.

Indian IT companies are too big to become irrelevant

The Indian IT services sector currently employs over 3.5mn people in India and across the world. They serve over 240 of the Fortune 500 companies in the world; their total list of clients far exceeding 1000. Simply put, the world cannot do without Indian IT services companies. They might fail to grow over the next few years, deliver inferior returns to the shareholders, but will not vanish.

Indian IT is well entrenched

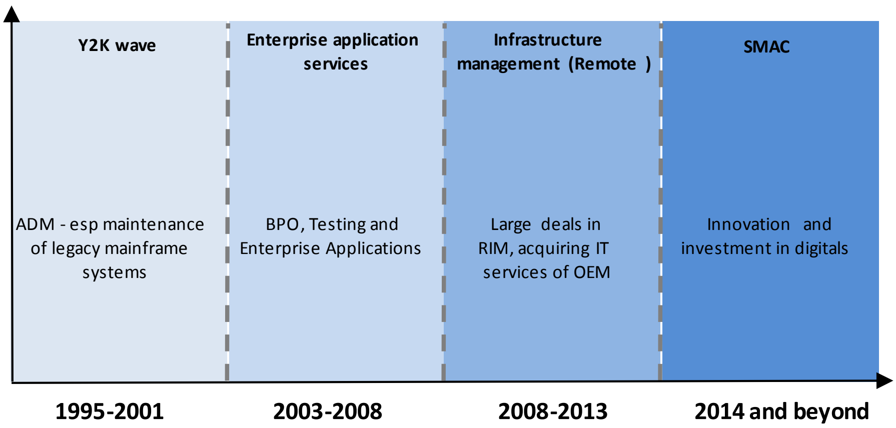
BFSI	Manufacturing	Oil & Gas	Telecom	Retail	Pharma	Travel and logistic
JPMorgan Chase	General Electric	Exxon Mobil	AT&T	Wal-Mart Stores	Cardinal Health	British Airways
Wells Fargo	BHP Billiton	BP	Deutsche Telekom	PepsiCo	GlaxoSmithkline	Ferrari Scuderia
Bank of America	Boeing	Chevron	Nokia	Home Depot	Boots	Toyota Motor
Citigroup	United Technologies	ConocoPhillips	NTT	Nestle	Aventis	Volkswagen Group
BNP Paribas	Rio Tinto	Shell	Telefonica	Procter & Gamble	Hoffmann La Roche	Ford Motor
Allianz	Holcim	ENI	Telstra	Coca-Cola	Johnson& Johnson	Bombardier
Banco Santander	Dow Chemical		Telstra	Unilever	Merck	AIRBUS
Commonwealth Bank	ArcelorMittal		Verizon Communications	Carrefour	Misys Healthcare	KLM
Goldman Sachs Group	Cummins		Hutchinson 3G	P&G	Novartis	FIAT
National Australia Bank	Chrysler		Motorola		CVS Caremark	
American Express	ABB		Vodafone			
Morgan Stanley			Telenor			
Prudential						
Barclays						
Deutsche Bank						

Source: Companies, PhillipCapital India Research

Third wave of IT development – Indian companies will still be the laggards

Indian IT companies have historically come towards the later stage of any technological wave. Whether it was the maintenance of the legacy COBOL-based banking platforms, or the Y2K boom, or the current replacement of the legacy systems with the latest architecture, global MNCs (such as IBM, Accenture) have captured the early adapters phase (the most lucrative one) and the Indian IT companies have gradually developed capabilities in those domains, capturing large share in the mature phase.

Waves of global IT industry



The entire excitement about the upcoming digital transformation wave was that the Indian IT companies were, for the first time, competing with the global peers on a level playing field. The digital space is as new for the global peers, as it is for them. Hence, Indian IT companies do not have to fight the legacy issues, which have offered the global peers an advantage in all the cycles until date.

However, as is evident from the utilization of cash over the last decade and investment in building/acquiring delivery capabilities in the digital space, Indian IT companies are far behind the global peers large and small (or at least perceived to be). Hence, while we see Indian IT companies losing out on encashing the early adapters phase, they will definitely develop capabilities over the next 3-4 years and emerge as significant competition in the mature phase of the digital transformation wave.

A small case in point is migration to cloud platforms — while cloud platforms are expected to cannibalise a large share of the current IT services business (especially IMS), most enterprises (after moving to cloud) would need multiple cloud-based applications to be developed and customized as per their requirements. This is where Indian IT services companies will find their footing again and be able to compete with global peers.

However, we expect at least 3-4 years for this to take place – for the digital transformation wave to reach a mature stage and the enterprises feeling the need for third-party application developers on their new digital platforms. Until then, we see Indian IT services companies lagging significantly in terms of capitalizing the digital opportunity even as they see their traditional business lines being eroded by the digital wave.

So why downgrade now – what has changed?

The lack of investments in building/acquiring delivery capabilities took place over the last decade, which should have rung alarm bells. The start-up boom has been on the ground for over two years now, so has the issue of dearth of people with relevant skills in the digital space. What has promoted us to change our view on the industry *now*?

Five factors:

1) **Four consecutive quarters of muted growth:** Over the last four quarters, almost all top Indian IT companies have reported lower-than-expected organic revenue growth. This provides evidence of a possible slowdown. The results of the first half of FY16 imply that most companies will report single-digit organic growth in dollar revenues, paving the way for a weak FY17 and beyond. Add to that, the persisting weakness in telecom, E&U, and retail verticals, call for a perfect recipe for downgrade of FY17 street estimates, which are still sitting pretty high on double-digit growth.
2) **Fresher salary hike by TCS after seven years:** We see this as evidence of the company, and hence the industry, facing supply-side challenges. While they would have given a hike at some point or the other, the concurrence of the salary hike with a boom in the Indian IT start-up landscape is too big a coincidence. We see these supply-side challenges persisting for the next 3-4 years.
3) **Small niche companies stealing the show:** Over the last few months, we have seen an increasing level of interest among enterprises for small niche Silicon Valley based companies for their digital transformation deals. While they might not be the eventual recipients of contracts, enquiries have continuously been increasing.
4) **AWS and Azure stepping up the heat:** Companies like Amazon and Google have recently stepped up the heat in the IaaS space. Over the last six months, they have started offering platforms for application development with easy access to a host of APIs, which they are now offering to enterprise customers as a package deal along with their cloud hardware and migration support. This, in our opinion, is akin to the coffin closing, for the Indian IT companies.
5) **SMEs putting their IT modernisation plans on hold:** This is the final nail in the coffin. Our interactions with industry experts reveal that large number of small and medium enterprises, are putting their IT modernization plans (traditional or digital) on hold. They prefer sitting on the fence right now and watching market leaders implementing their digital solutions; they would then take a call on which technology/platform/vendor to award their contract to. This means that the new clients (which the industry was banking on to mitigate the cannibalization of their traditional revenue stream by the digital wave) are not yet willing to spend – this will make the recovery curve even more prolonged than anticipated before.

Mid-teen revenue growth in FY17; cast in stone?

Bloomberg estimates predict mid-teen USD revenue growth for FY17 for the top-4 Indian IT services companies (except for Wipro). Expectations are driven by positive commentary from companies and anticipation of incremental outsourcing contracts from under-penetrated geographies such as Europe. We believe FY17 estimates are in for a big reset. Almost all top-4 Indian IT services companies will find it difficult to report mid-teen organic revenue growth and will barely manage to touch double-digit in FY17. Our thesis is based on the following analysis:

Visible deceleration in the last four quarters

Over the last four quarters, almost all the top Indian IT companies have reported lower-than-expected revenue growth in organic terms. While cross-currency impact has played it part, CC growth has also been rather muted. Average rolling annualised USD revenue growth for the top-4 in the last four quarters has been a muted 5%. In fact, on the dismal performance in the first two quarters, we do not expect any of the top-4 companies to report double digit organic growth in FY16. With the deal-flow in FY16 almost at similar levels as FY15, we see no reason for this to jump into double digits in FY17.

YoY growth of Top-5 Indian IT companies

% yoy growth	FY13	FY14	FY15	FY16E
TCS	13.7	16.2	15.0	9.1
Infosys	5.8	11.5	5.6	8.1
Wipro	5.0	6.4	7.0	4.7
HCL Tech	12.5	14.1	12.4	13.3
Tech Mahindra	6.7	17.7	18.3	12.6

Organic growth of Top-5 Indian IT companies

% yoy growth	FY13	FY14	FY15	FY16E
TCS	13.7	15.0	16.1	9.1
Infosys	4.2	9.3	9.3	7.8
Wipro	5.0	6.4	4.3	7.4
HCL Tech	12.5	14.1	12.4	13.3
Tech Mahindra	6.7	17.7	15.0	2.5

Quarterly growth of Top-5 Indian IT companies

% qoq growth	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15
TCS	6.4	0.1	(0.8)	3.5	3.0
Infosys	3.2	0.8	(2.7)	4.5	6.0
Wipro	1.8	1.3	(1.2)	1.1	2.1
HCL Tech	1.9	4.0	(0.0)	3.2	0.4
Tech Mahindra	5.2	2.7	6.5	0.5	2.2

Source: Companies, PhillipCapital India Research

Slowdown in key verticals of telecom, E&U, and retail

All IT services companies (apart from TechM) have been reporting slowdown in the telecom domain for over six quarters now. Even TechM, which had been long bucking the trend, spoke of weakness in the sector in its 2QFY16 conference call. None of the companies expects the sector to rebound over the next few quarters.

The retail sector, on the other hand, has been highly volatile. While 3Q has traditionally been weak for the retail sector (due to festive discounts and furloughs), the overall growth in the sector has been tepid over the last six quarters. BFSI sector, by far the largest revenue generator for Indian companies, has seen a delay in discretionary spending leading to muted growth. Lastly, weakness in the energy & utilities sector, caused by the low energy prices (though it forms meaningful part of only Wipro's portfolio), has been dragging overall growth for companies.

Cumulatively, these three verticals (Telecom, Retail and BFSI) contribute to over 65% of the total revenue of the top-4 Indian IT companies. With weakness expected to continue in 65% of revenues – we do not expect strong growth in the overall revenue profile of the companies.

Growth trends in telecom vertical

% yoy growth	FY13	FY14	FY15	% qoq growth	Dec-14	Mar-15	Jun-15	Sep-15
TCS	5.7	11.6	7.3	TCS	0.1	(9.7)	9.9	0.6
Infosys	0.6	(4.5)	9.8	Infosys	(1.5)	(7.1)	5.8	(0.3)
Wipro	(3.9)	2.2	7.7	Wipro	0.6	(3.3)	(1.1)	3.6
HCL Tech	8.9	26.4	12.1	HCL Tech	0.5	7.1	8.9	1.5
Tech Mahindra	-	26.6	25.7	Tech Mahindra	0.5	15.7	(4.2)	2.6

Growth trends in retail vertical

% yoy growth	FY13	FY14	FY15	% qoq growth	Dec-14	Mar-15	Jun-15	Sep-15
TCS	21.2	18.4	13.8	TCS	(0.5)	(0.2)	5.3	3.6
Infosys	9.5	7.9	1.5	Infosys	(1.6)	(0.9)	3.2	8.0
Wipro	5.3	4.3	2.5	Wipro	2.8	1.6	4.6	2.7
HCL Tech	16.7	8.7	19.1	HCL Tech	6.2	(13.4)	8.1	0.4
Tech Mahindra	-	17.7	12.0	Tech Mahindra	9.5	3.1	5.4	(5.6)

Growth trends in BFSI vertical

% yoy growth	FY13	FY14	FY15	% qoq growth	Dec-14	Mar-15	Jun-15	Sep-15
TCS	13.8	15.8	9.2	TCS	0.3	(0.5)	3.5	2.7
Infosys	2.2	10.3	4.7	Infosys	1.7	(1.2)	2.9	5.1
Wipro	3.9	5.9	5.8	Wipro	0.2	1.9	2.2	1.7
HCL Tech	15.3	22.5	10.5	HCL Tech	(1.9)	(1.9)	2.8	0.8
Tech Mahindra	-	4.4	20.6	Tech Mahindra	0.6	(1.1)	10.4	(1.9)

Source: Companies, PhillipCapital India Research

Nasscom guidance – trending on the more optimistic side, than realistic

The basic guiding principle for analysts in estimating the growth profile of IT companies (apart from management guidance/commentary) has always been Nasscom guidance. The industry body has historically been right more often than being wrong and top-4 Indian IT companies have consistently beaten industry guidance (apart from a period when Infosys and Wipro have 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 the top-4 came closer to the lower end of guidance. In FY16, we expect all top-4 Indian IT companies to miss the Nasscom guidance, thereby taking overall industry growth to below Nasscom estimates of 12-14% constant currency growth. As fallout, we expect Nasscom's CY16 guidance to be much lower than CY15.

Nasscom guidance trends

	FY11	FY12	FY13	FY14	FY15	FY16
NASSCOM guidance	13-15%	16-18%	11-14%	12-14%	13-15%	12-14%
Industry growth	18.7%	16.5%	10.2%	13.0%	13.0%	-

Source: NASSCOM, Companies, PhillipCapital India Research

We believe that most of the top Indian IT services companies will find it difficult to grow in double digits over the next few years, primarily due to the changing landscape of the industry and the under-preparedness of the companies due to lack of investment in building delivery capabilities over the last decade. Digital transformation is the new paradigm of the IT services industry and we find Indian IT companies significantly behind in terms of delivery capabilities (or rather perceived delivery capabilities) in this domain.

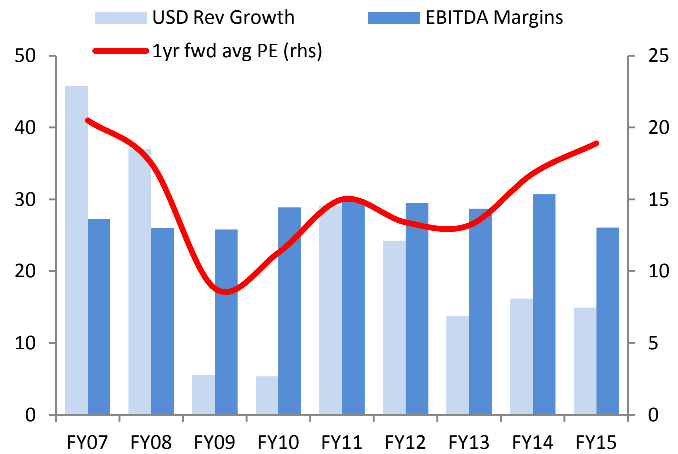
Expensive valuations – considering near-term growth concerns

The IT sector hasn't reported stupendous results over the last six months, but stocks haven't corrected much. We believe that current valuations do not factor the kind of slowdown we have highlighted in this report. With consensus still sitting at double-digit growth for the top-4 in FY17, downgrades are imminent. Along with earnings downgrade, we expect stock valuations to be also de-rated based on the bleak growth scenario over the next 2-3 years.

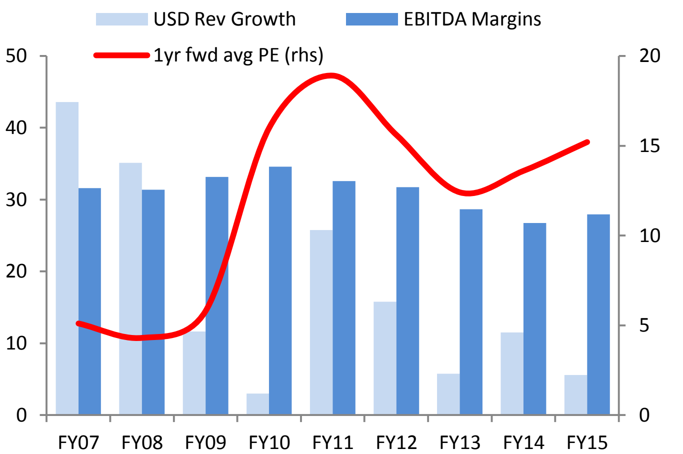
We find current valuations expensive (excluding few companies) because:

1) Double-digit growth in FY17 looks unlikely
2) With continued investments in S&M and digital, margins will be under pressure to remain flat in best-case scenario
3) With topline growing in single digits and margins under pressure, earnings will report muted single-digit growth
4) Current valuations of ~15x FY17 P/E are in line with historical average, but do not factor slowdown over the next three years.

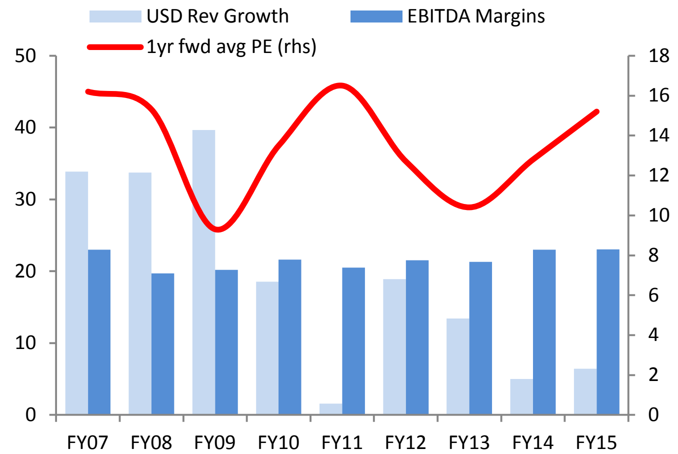
TCS – multiple vs growth/margins



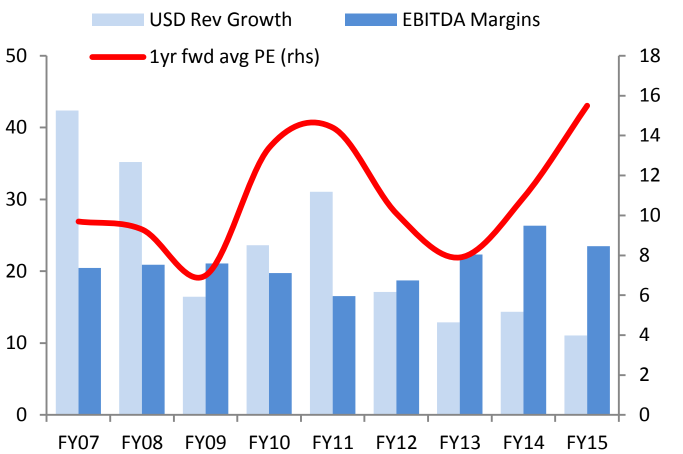
Infosys – multiple vs growth/margins



Wipro – multiple vs growth/margins



HCL Tech – multiple vs growth/margins



Source: Companies, Bloomberg, PhillipCapital India Research

We also see valuations remaining under pressure because of expected revival in broader economy and the market moving towards cyclical sectors with higher earnings and growth potential (capital good, infrastructure).

Key downgrades

Tech Mahindra (SELL) – Back to where it started from

While Satyam's acquisition had catapulted TechM into the top-5 bracket – with its revenue base diversifying across verticals and margins expanding – its badly managed acquisition of LCC has undone all the good over the last few years, in our opinion. After LCC's integration, TechM has over 50% of its revenue coming from Communication (which the management itself has eluded to facing challenges) and its operating margins are in 14-15% range – both key traits of a mid-cap IT Services company.

We are 10% below consensus in our FY17, FY18 EPS estimates for Tech Mahindra

TechM is expected to deliver organic CC growth of only 5% in FY16 – casting significant doubts over the future growth potential. We expect the stock to be derated – to multiple inline with mid-cap valuations. We downgrade our FY17 earnings estimate (by -9%) and multiple to 12x (earlier 15x). We downgrade to SELL with PT of Rs 420.

Wipro (SELL) – Turnaround nowhere in sight

Over the last six quarters, Wipro has consistently disappointed in terms of its growth rate. Strong deal-wins in FY15 (US$ 3bn as compared to US$ 1.55bn in FY14 – *announced large deals*) led to the belief that it was finally turning the corner. However, the same has not translated into revenue growth as it continues to lose large part of its existing business to competitors. In FY16, we expect Wipro to report USD revenue growth of 4% – lowest in the top-4 bracket. We do not see the scenario changing much over the next 2-3 years, and expect the company to lag its peers.

We are 5% below consensus in our FY17, FY18 EPS estimates for Wipro

Wipro's relatively high exposure to E&U vertical (16% of revenues) is also expected to keep the growth subdued. With another round of management reshuffle likely in near future, we expect the recovery curve for the company to be elongated further. It is trading at 14x FY17 P/E, at a discount to TCS and Infosys, but at par with HCL Tech - for which we see no possible justification. We downgrade our earnings estimate (by -2%) and multiple to 12x (earlier 14x). We downgrade to SELL with PT of Rs 490.

TCS (NEUTRAL) – Losing momentum; valuation to be capped

TCS is now a giant, in terms of its size. Its FY16 topline of US$ 16bn is in catching distance of Fortune 500 companies of the world (Wuhan Iron & Steel being the last with topline of US$ 18bn). For the company to grow in double digits on this base, implies adding US$ 2bn revenues annually – a herculean task for any company. We believe the last four quarters of below-expectations growth are clear indications of the engine slowing down.

We are 2% and 4% below consensus in our FY17 and FY18 EPS estimates for TCS

Also, TCS has been highly inefficient in term of utiization of its cash reserves, over the last decade. Over the last 10 years, it generated Rs 866bn of OCF, and paid 37% as dividends - utilizaing only 6% for acquisitions.

Currently, TCS is trading at 18 FY17 P/E, a 10% premium to Infosys. 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 by FY18. We see the growth and consistency premium (which TCS has commanded over the last three years over Infosys) vanishing over the next three years. We downgrade our FY17 estimates by -4% and our target multiple to 18x (from earlier 20x). We downgrade to NEUTRAL with PT of Rs 2550

Few stocks still look attractive

However, even in this gloomy scenario, we find pockets of excitement. We expect Infosys, Mindtree and NIIT Tech to continue to do well, and see significant upside from current levels. In an overall sector downgrade, we maintain our BUY rating on these stocks.

Infosys (BUY): All set to regain the bellwether tag

We expect Infosys to regain its industry leading position, as TCS starts decelerating (large base, lack of inorganic drivers). Over the last six quarters, Infosys has shown remarkable improvement in client metrics and dealwins. The number of +US$ 200mn clients has increased to six from three. Similarly, number of +US$ 100/50/30mn clients increased to 14/50/85 from 13/42/70. It has reported deal-wins of US$ 1.67bn in 1HFY16 – already 85% of the total deal-wins in FY15 (US$ 1.95bn). We see this improvement in deal-wins and higher share of large clients leading to a momentum that will propel Infosys to industry-leading growth in FY18.

We are inline with consensus in our FY17 and FY18 EPS estimates for Infosys

Infosys has shown the right intent by acquiring Panaya, Kalidus and Noah Consulting – niche companies in the digital space – over the last six months. We expect the stock to be re-rated to 18x (from the current 16x). At the same time, we expect TCS to be derated from to valuations at par with Infosys. We maintain our estimates and target multiple (18x) to arrive at PT of Rs 1270. We maintain BUY.

Mindtree (BUY): Another large cap in the making

Mindtree (MTCL) is on its way to becoming a large IT-services company — evident from its strategy of focusing on multiple segments through expertise-driven client engagements and alignment its portfolio to growth areas, such as digital and product engineering. It currently has the perfect mix of emerging businesses – digital (35%) and ER&D (20%). We expect this portfolio composition to lead to strong organic growth over the next three years.

We are 10% ahead of consensus in our FY17 and FY18 EPS estimates for Mindtree

MTCL has maintained acquisition is one of the pillars of its growth strategy and has set a goal of inorganic revenues to constitute 10% of its revenue by 2020. Its recent acquisition of Discoverture Bluefin and Relational Solutions are in all in the digital space - to enhance its delivery capabilities. We expect revenue CAGR of 18% over FY15-17 — highest in our coverage universe. We maintain our estimates and target multiple (16x) to arrive at PT of Rs 1620. We maintain BUY.

NIIT Tech (BUY): Changing DNA, rerating imminent

Ever since Sudhir Chaturvedi took over as COO of NIIT Tech, it has executed its trategy with great precision - its IMS revenues have grown by 55% in last two years, contribution from US has increased to 44% from 37%, and contribution from government business has reduced to 5% from 15%. This changed DNA and clear focus, in our opinion, will lead to accelerated revenue growth over the next three years.

We are 1% and 7% ahead of consensus in our FY17 and FY18 EPS estimates for NIIT Tech

NITEC has also set out to increase its digital presence by hiring Graham Clark to head the digital business and acquiring Incessant Technologies. Currently 14% of its business is from digital. We believe with large accounts in travel and transport, and customer experience being one of the biggest spending areas in digital, NITEC is well placed to gain share in the digital wallet of its clients. At 12x FY17 P/E, the stock appears fairly inexpensive. We maintain our estimates and target multiple (12x) to arrive at PT of Rs 645. We maintain BUY.

Changes to our estimates and valuations

We have downgraded our assumptions across the sector for FY17. We now build in a muted single-digit USD growth in revenues for almost all companies (excluding Infosys, HCL Tech, Mindtree and NIIT Tech), leading to similar growth in earnings.

We also downgrade our multiples for most companies (excluding Infosys, Mindtree and NIIT Tech), on lower visibility and growth concerns over the next three years.

Our USD-INR assumption for 2HFY16, FY17 and FY18 are at 65

Revision of estimates (FY17)

		TCS	HCL Tech	Wipro	TechM	Persistent	KPIT
USD Revenue	New	18,467	7,331	8,350	4,476	367	546
$ mn	Old	19,072	7,468	8,603	4,714	380	550
	Change	*-3%*	*-2%*	*-3%*	*-5%*	*-3%*	*-1%*
EBITDA	New	326	106	112	48	4,549	4,432
(Rs bn)	Old	334	111	114	53	4,681	4,435
	Change	*-2%*	*-4%*	*-2%*	*-8%*	*-3%*	*0%*
EBITDA Margins	New	27.2%	22.2%	20.6%	16.6%	13.9%	12.5%
	Old	26.9%	22.8%	20.4%	17.1%	13.9%	12.4%
	Change	*24*	*-59*	*11*	*-53*	*5*	*8*
PAT	New	264	85	96	31	3,326	2,879
(Rs bn)	Old	275	89	97	34	3,425	2,853
	Change	*-4%*	*-4%*	*-2%*	*-9%*	*-3%*	*1%*
EPS	New	134	60	39	33	41.6	14.4
(Rs)	Old	140	63	39	36	42.8	14.3
	Change	*-4%*	*-4%*	*-2%*	*-9%*	*-3%*	*1%*

We are significantly below consensus on Wipro, Tech Mahindra and Persistent – and marginally below consensus on TCS and HCL Tech.

We are significantly ahead of consensus on Mindtree

Our estimates vs Consensus

			TCS	Infosys	Wipro	Hcl Tech	TechM	Mindtree	Persistent	KPIT	NIIT Tech
Revenue	PC	FY17	12,00,337	6,79,380	5,42,755	4,76,510	2,90,936	53,023	23,880	35,491	30,367
Rs mn		FY18	13,04,693	7,60,739	5,77,586	5,24,193	3,17,100	60,449	26,058	39,024	34,069
	Consensus	FY17	12,29,800	6,90,410	5,60,033	4,74,840	2,99,621	53,215	25,773	36,147	30,584
		FY18	13,80,685	7,76,650	6,13,145	5,31,991	3,34,753	61,015	29,636	39,973	34,175
	Deviation	FY17	-2.4	-1.6	-3.1	0.4	-2.9	-0.4	-7.3	-1.8	-0.7
		FY18	-5.5	-2.0	-5.8	-1.5	-5.3	-0.9	-12.1	-2.4	-0.3
EBITDA	PC	FY17	3,26,174	1,90,852	1,11,564	1,05,693	48,296	10,749	4,549	4,432	5,028
Rs mn		FY18	3,52,143	2,16,188	1,18,662	1,16,328	53,215	12,228	5,011	4,833	5,713
	Consensus	FY17	3,49,970	1,93,042	1,24,361	1,07,461	52,534	10,100	5,337	4,856	5,218
		FY18	3,89,349	2,17,278	1,35,515	1,19,884	59,227	11,453	6,072	5,590	5,752
	Deviation	FY17	-6.8	-1.1	-10.3	-1.6	-8.1	6.4	-14.8	-8.7	-3.6
		FY18	-9.6	-0.5	-12.4	-3.0	-10.2	6.8	-17.5	-13.5	-0.7
PAT	PC	FY17	2,63,768	1,51,849	95,550	84,975	31,403	7,970	3,326	2,879	3,018
Rs mn		FY18	2,92,037	1,70,859	1,03,788	94,642	35,810	9,066	3,712	3,291	3,523
	Consensus	FY17	2,70,057	1,51,785	1,00,615	87,753	35,121	7,245	3,643	3,034	2,991
		FY18	3,04,789	1,70,612	1,10,285	98,609	40,565	8,274	4,184	3,509	3,279
	Deviation	FY17	-2.3	0.0	-5.0	-3.2	-10.6	10.0	-8.7	-5.1	0.9
		FY18	-4.2	0.1	-5.9	-4.0	-11.7	9.6	-11.3	-6.2	7.4

Recommendations Summary

	CMP	Mkt Cap	Multiple	PT	Upside	Rating	USD Rev Growth		EBITDA Margins		EPS (Rs)	
	Rs	Rs bn		Rs	%		FY17	FY18	FY17	FY18	FY17	FY18
TCS	2,445	4,802	18	2,550	4%	NEUTRAL	9.5	8.7	27.2	27.0	134	149
Infosys	1,100	2,514	18	1,270	15%	BUY	11.0	12.0	28.1	28.4	66	75
Wipro	557	1,371	12	490	-12%	SELL	6.2	6.4	20.6	20.5	39	42
HCL Tech	856	1,209	14	900	5%	NEUTRAL	11.2	10.0	22.2	22.2	60	67
Tech Mahindra	522	502	12	420	-20%	SELL	8.5	9.0	16.6	16.8	33	37
MindTree	1,480	124	16	1,625	10%	BUY	16.1	14.0	20.3	20.2	95	108
Persistent	667	53	12	530	-21%	SELL	10.0	9.1	19.1	19.2	42	46
KPIT	170	32	9	140	-18%	SELL	10.1	10.0	12.5	12.4	14	16
NIIT Tech	586	36	12	650	11%	BUY	10.2	12.2	16.56	16.77	50	58

Source: Companies, Bloomberg, PhillipCapital India Research

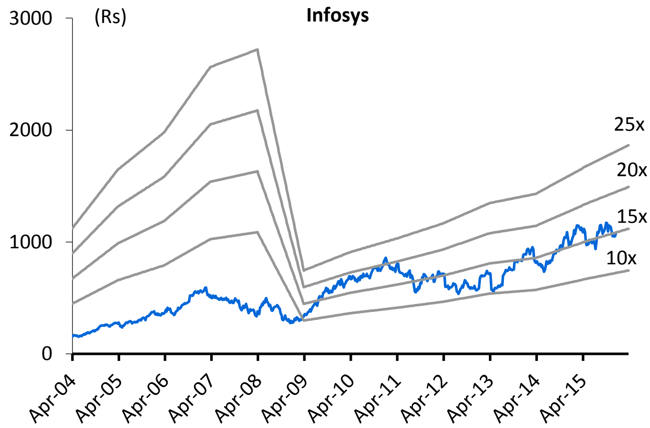
Financials and valuation snapshot

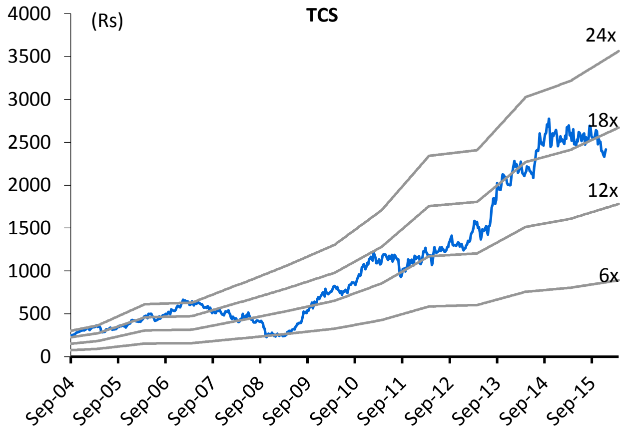
	$ Revenue Growth			EBITDA Margins			EPS			EPS Growth		
Companies	FY16E	FY17E	FY18E	FY16E	FY17E	FY18E	FY16E	FY17E	FY18E	FY16E	FY17E	FY18E
TCS	9.1	9.5	8.7	28.4	27.2	27.0	126	134	149	13.9	6.7	10.7
Infosys	8.1	11.0	12.0	27.1	28.1	28.4	57	66	75	6.2	16.0	12.5
Wipro	3.0	6.2	6.4	21.8	20.6	20.5	37	39	42	5.8	4.6	8.6
HCL Tech	10.8	11.2	10.0	22.0	22.2	22.2	53	60	67	2.5	14.1	11.4
Tech Mahindra	33.2	8.5	9.0	15.9	16.6	16.8	30	33	37	7.5	9.3	14.0
MindTree	20.4	16.1	14.0	18.7	20.3	20.2	75	95	108	16.7	27.1	13.7
Persistent	8.2	10.0	9.1	19.3	19.1	19.2	37	42	46	1.1	13.2	11.6
KPIT	1.4	10.1	10.0	12.2	12.5	12.4	13	14	16	9.2	11.4	14.3
NIIT Tech	9.3	10.2	12.2	17.1	16.6	16.8	46	50	58	42.7	9.1	16.7

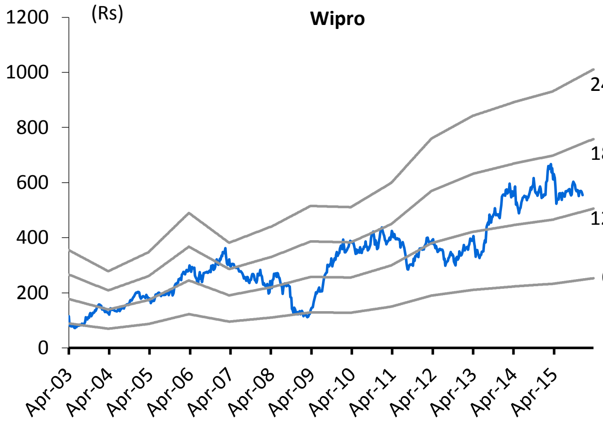
	ROE			PE			PB			EV/EBITDA		
Companies	FY16E	FY17E	FY18E	FY16E	FY17E	FY18E	FY16E	FY17E	FY18E	FY16E	FY17E	FY18E
TCS	36.1	32.0	29.8	19.4	18.2	16.4	7.0	5.8	4.9	15.4	14.6	13.4
Infosys	23.2	23.9	23.7	19.2	16.6	14.7	4.5	4.0	3.5	13.0	11.2	9.7
Wipro	19.6	18.1	17.4	15.0	14.3	13.2	2.9	2.6	2.3	11.3	10.6	9.7
HCL Tech	25.9	25.2	24.2	16.2	14.2	12.8	4.2	3.6	3.1	12.0	10.5	9.3
Tech Mahindra	18.3	17.4	17.2	17.5	16.0	14.0	3.2	2.8	2.4	11.4	9.9	8.5
MindTree	25.4	26.0	24.1	19.8	15.6	13.7	5.0	4.0	3.3	14.2	11.2	9.5
Persistent	18.1	17.7	17.1	18.2	16.0	14.4	3.3	2.8	2.5	12.4	11.4	10.2
KPIT	15.8	15.0	14.7	13.2	11.8	10.3	2.1	1.8	1.5	8.4	7.0	6.0
NIIT Tech	17.6	16.8	17.0	12.8	11.8	10.1	2.3	2.0	1.7	6.9	6.9	5.6

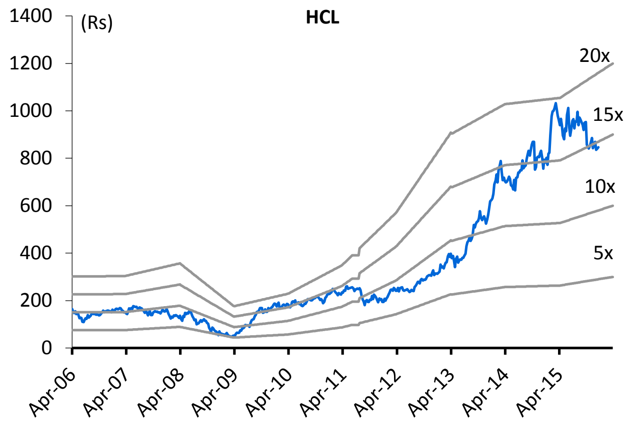
Source: Companies, PhillipCapital India Research

Historic valuation charts









Source: Company, PhillipCapital India Research

Where could we be wrong?

Our stance on the IT sector in this report is contrary to the consensus stand. Not only are we significantly below street expectations in our FY17/18 estimates, our take on Indian IT companies lagging global/niche players in the digital transformation cycle is also completely opposite to the general consensus view that Indian IT companies are at par with competition.

We believe that as FY17 results are declared by companies, the consensus will gradually tone down expectations and move towards our estimates. Fewer and smaller deals in the digital space will also lead to a slow realization that the Indian companies do not, or at least are perceived not to, have the same capabilities in the digital space as global peers such as Accenture or niche companies like Mu Sigma.

So where could we go wrong? We see the following risks to our hypothesis:

1) **Currency depreciation:** Further depreciation in USD-INR will provide significant boost to margins/earnings, which could make stocks look attractive.
   Probability of occurrence: Low; dependent on macro factors

2) **Big-ticket acquisition in the digital space:** This will provide the acquirer with delivery capabilities in the digital space almost overnight, along with access to clients. While it might appear to be a game changer, we believe a big-ticket acquisition will have its own integration issues and might be long drawn out. Small-sized acquisition will not add much incrementally.
   Probability of occurrence: Low

3) **Resurgence in traditional IT contracts:** Many new clients that have never outsourced IT operations might shrug the digital wave and go ahead with traditional IT modernization contracts (as many are currently doing), which more than mitigates the cannibalization of revenues by digital contracts.
   Probability of occurrence: Significantly low

4) **Indian IT companies *have* in-house digital capabilities:** This would very likely completely finish our hypothesis and would enable Indian IT companies to secure large digital contracts on their own, leading to high double-digit growth in topline and strong earnings growth.
   Probability of occurrence: Low

Overall, apart from the currency risk, we do not see significant risks to our hypothesis and the probability of those risks playing out appears to be quite low.

Companies Section

INSTITUTIONAL EQUITY RESEARCH

Infosys (INFO IN)

All set to regain the bellwether tag

INDIA | IT SERVICES | Company Update

22 December 2015

Ready to lead again

Over the last twelve months, Infosys has shown a remarkable turnaround – not necessarily in actual topline/earnings, but in other supporting metrics. Number of large clients has increased significantly. Deal wins in FY16 YTD are already 85% of the entire FY15 and the acquisitions that it has made are all to enhance its delivery capability (or perceived delivery capability) in the digital space. We expect the company to report industry-leading growth in FY18, 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 six quarters, the number of +US$ 200mn clients for Infosys has increased to six from three. Similarly, number of +US$ 100/50/30mn clients increased to 14/50/85 from 13/42/70. Total clients count has also increased to 1011 from 890, which shows remarkable success in adding new clients and capturing higher share of their wallets. The company has reported deal-wins of US$ 1.67bn in 1HFY16 – already 85% of the total deal-wins in FY15 (US$ 1.95bn). We see this improvement in deal-wins and higher share of large clients leading to a momentum that will propel Infosys to industry-leading growth in FY18.

Strategic acquisitions: The only IT company among the top-4 looking to make amends

Over the last 10 years, Infosys generated Rs 581bn of OCF and paid out 41% of this cash as dividends, and 49% is sitting as cash/investments. It did not acquire any company of significant size/capability apart from Lodestone in 2012. However, it appears to be the only company looking to make amends. Over the last eight months, it 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. The company 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 form this paradigm shift in strategy and capture larger share of digital deals in coming years on these niche acquisitions.

Automation and AI strategy to have back-ended impact

We believe that Infosys' strategy of focusing on a more strategic role with clients through design thinking and artificial intelligence will yield highly back-ended results. While the strategy is right for the future (to move away from commoditized services to more strategic roles with clients), the near term investments in the process will be huge. Already it is spending significant resources on training a large part of its staff on design thinking. The key will be to maintain a balance between developing capabilities for the future and maintaining focus on the current revenue generating streams – something that the company failed to do in its last strategy.

Valuations to come at par with TCS

Currently Infosys is trading at 16.5x FY17 P/E – a 10% 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 by FY18. If it continues on the growth path, we expect Infosys to trade at a premium to TCS in the medium to long term.

We keep our FY16/17 estimates intact and introduce FY18 estimates. We roll forward our valuation to 18x (same multiple as before) average of FY17-18 P/E – at par with TCS. Our price target of Rs 1270 (Rs 1200 earlier) offers 15% upside from current levels. We maintain BUY – our only BUY recommendation in the top-4 bracket.

BUY (Maintain)

CMP RS 1100

TARGET RS 1270 (+15%)

COMPANY DATA

O/S SHARES (MN) :	2297
MARKET CAP (RSBN) :	2474
MARKET CAP (USDBN) :	36.9
52 - WK HI/LO (RS) :	1219 / 933
LIQUIDITY 3M (USDMN) :	63.8
PAR VALUE (RS) :	5

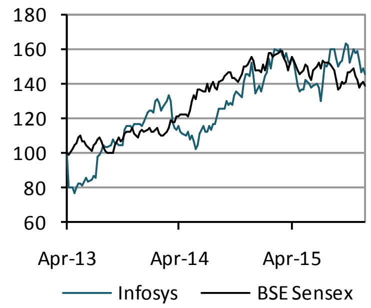
SHARE HOLDING PATTERN, %

	Sep 15	Jun 15	Mar 15
PROMOTERS :	13.1	13.1	13.1
FII / NRI :	39.9	41.0	38.0
FI / MF :	17.2	16.1	15.1
NON PRO :	7.3	7.3	11.1
PUBLIC & OTHERS :	22.6	22.5	22.7

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	-2.1	-2.0	11.9
REL TO BSE	-1.0	-0.5	19.2

PRICE VS. SENSEX



Source: Phillip Capital India Research

KEY FINANCIALS

Rs bn	FY16E	FY17E	FY18E
Net Sales	609.9	679.4	760.7
EBIDTA	165.2	190.9	216.2
Net Profit	130.9	151.8	170.9
EPS, Rs	57.3	66.4	74.8
PER, x	19.3	16.6	14.8
EV/EBIDTA, x	13.3	11.3	9.7
P/BV, x	4.5	4.0	3.5
ROE, %	23.2	23.9	23.7

Source: PhillipCapital India Research Est.

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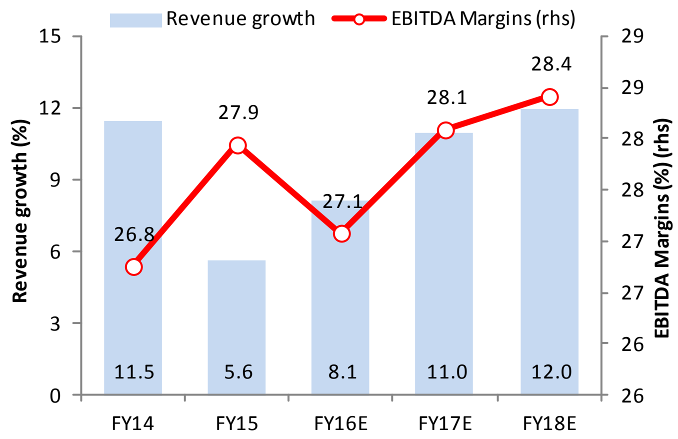
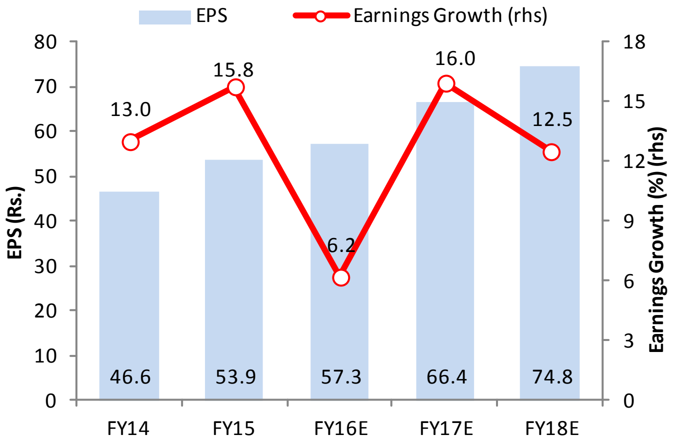
USD revenue growth (%) and EBITDA margins (%)



EPS (Rs) and earnings growth (%)



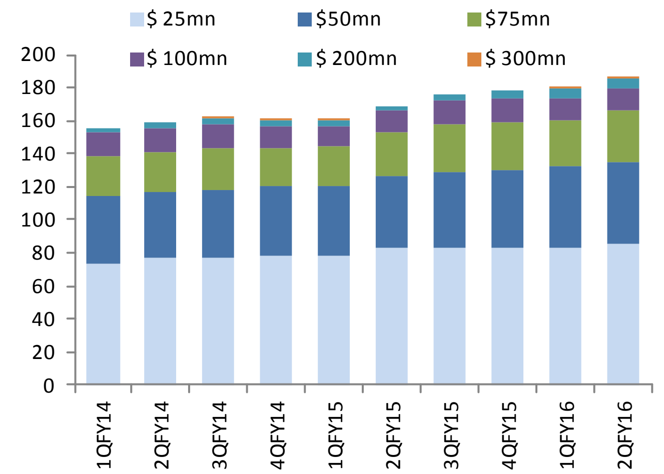
Source: Company, Phillip Capital India Research

Source and utilization of cash generated over the last decade

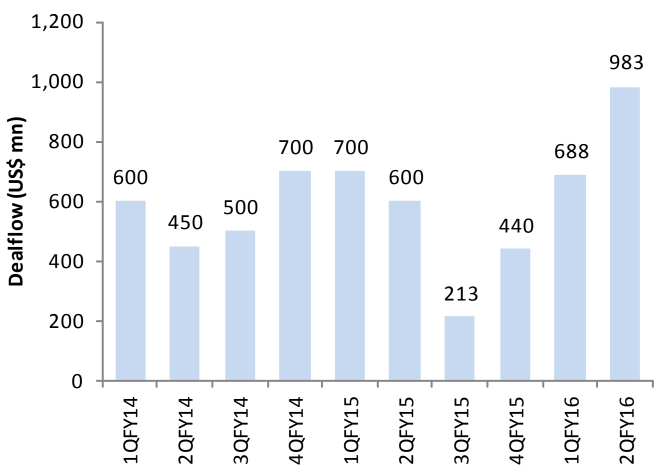
Revenue (Rs mn)	28,95,800	Dividend (Rs mn)	2,40,310	Dividend Payout Ratio	34.1
PAT (Rs mn)	7,04,165	CAPEX (Rs mn)	1,59,880	Dividend as % of OCF	41.3
OCF (Rs mn)	5,81,590	Cash Added (Rs mn)	2,85,140	Capex as % of OCF	27.5
FCF (Rs mn)	4,21,710	Acquisitions (Rs mn)	37,030	Acquisitions as % of OCF	6.4

Source: Company, Phillip Capital India Research

Significant improvement in client metrics



Delaflow has improved significantly over last four quarters



Source: Company, Phillip Capital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Net sales	**533,190**	**609,929**	**679,380**	**760,739**
Growth, %	6.4	14.4	11.4	12.0
Employee expenses	-318,150	-369,585	-406,323	-452,502
Other Operating expenses	-66,040	-75,154	-82,205	-92,049
EBITDA (Core)	**149,000**	**165,190**	**190,852**	**216,188**
Growth, %	11.1	10.9	15.5	13.3
Margin, %	27.9	27.1	28.1	28.4
Depreciation	-10,680	-12,935	-13,255	-14,400
EBIT	**138,320**	**152,255**	**177,597**	**201,787**
Growth, %	14.9	10.1	16.6	13.6
Margin, %	25.9	25.0	26.1	26.5
Forex gains/losses	4,750	108	0	0
Other Non-Operating Income	29,510	30,763	34,780	37,176
Pre-tax profit	**172,580**	**183,127**	**212,376**	**238,963**
Tax provided	-49,290	-52,187	-60,527	-68,105
Profit after tax	**123,290**	**130,940**	**151,849**	**170,859**
Others (Minorities, Associates)	0	0	0	0
Net Profit	**123,290**	**130,940**	**151,849**	**170,859**
Growth, %	15.8	6.2	16.0	12.5
Net Profit (adjusted)	**123,290**	**130,940**	**151,849**	**170,859**
Wtd avg shares (m)	2,286	2,286	2,286	2,286

US$ Revenues

	FY15	FY16E	FY17E	FY18E
US$ Revenue ($ mn)	**8,711**	**9,418**	**10,452**	**11,704**
Growth, %	5.6	8.1	11.0	12.0
Re / US$ (rate)	61.2	64.8	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Cash & bank	312,410	331,988	368,892	423,409
Marketable securities at cost	0	0	0	0
Debtors	97,130	111,960	130,292	145,895
Inventory	0	0	0	0
Loans & advances	62,420	74,606	85,755	95,288
Total current assets	471,960	518,553	584,940	664,592
Investments	57,650	41,180	48,680	58,680
Net fixed assets	128,540	128,815	139,560	151,160
Non-current assets	0	0	0	0
Total assets	**661,460**	**690,738**	**775,370**	**876,622**
Total current liabilities	113,830	126,193	139,197	155,160
Non-current liabilities	0	0	0	0
Total liabilities	113,830	126,193	139,197	155,160
Paid-up capital	5,720	11,440	11,440	11,440
Reserves & surplus	541,910	553,105	624,733	710,022
Minorities	0	0	0	0
Shareholders' equity	547,630	564,545	636,173	721,462
Total equity & liabilities	**661,460**	**690,738**	**775,370**	**876,622**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Pre-tax profit	172,580	183,127	212,376	238,963
Depreciation	10,680	12,935	13,255	14,400
Chg in working capital	3,030	-14,652	-16,478	-9,173
Total tax paid	-49,910	-51,067	-60,527	-68,105
Other operating activities	0	0	0	0
Cash flow from operating activities	**136,380**	**130,343**	**148,626**	**176,086**
Capital expenditure	-35,360	-13,210	-24,000	-26,000
Chg in investments	-27,710	16,470	-7,500	-10,000
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-63,070**	**3,260**	**-31,500**	**-36,000**
Free cash flow	73,310	133,603	117,126	140,086
Equity raised/(repaid)	2,860	5,720	0	0
Debt raised/(repaid)	0	0	0	0
Dividend (incl. tax)	-160,313	-64,177	-80,221	-85,570
Other financing activities	106,493	-55,568	0	0
Cash flow from financing activities	**-50,960**	**-114,025**	**-80,221**	**-85,570**
Net chg in cash	22,350	19,578	36,904	54,517

Valuation Ratios

	FY15	FY16E	FY17E	FY18E
Per Share data				
EPS (INR)	53.9	57.3	66.4	74.8
Growth, %	15.8	6.2	16.0	12.5
Book NAV/share (INR)	239.6	247.0	278.3	315.6
CFPS (INR)	46.8	43.6	49.8	60.8
DPS (INR)	59.9	24.0	30.0	32.0
Return ratios				
Return on assets (%)	20.1	19.4	20.7	20.7
Return on equity (%)	22.5	23.2	23.9	23.7
Return on capital employed (%)	24.1	23.5	25.3	25.2
Turnover ratios				
Asset turnover (x)	3.3	3.4	3.4	3.4
Sales/Total assets (x)	0.9	0.9	0.9	0.9
Sales/Net FA (x)	4.6	4.7	5.1	5.2
Working capital/Sales (x)	0.1	0.1	0.1	0.1
Receivable days	66.5	67.0	70.0	70.0
Liquidity ratios				
Current ratio (x)	4.1	4.1	4.2	4.3
Quick ratio (x)	4.1	4.1	4.2	4.3
Dividend cover (x)	0.9	2.4	2.2	2.3
Net debt/Equity (%)	(67.6)	(66.1)	(65.6)	(58.7)
Valuation				
PER (x)	20.5	19.3	16.6	14.8
PEG (x) - y-o-y growth	1.3	3.1	1.0	1.2
Price/Book (x)	4.6	4.5	4.0	3.5
Yield (%)	5.4	2.2	2.7	2.9
EV/Net sales (x)	4.2	3.6	3.2	2.8
EV/EBITDA (x)	14.9	13.3	11.3	9.7
EV/EBIT (x)	16.0	14.4	12.1	10.4

INSTITUTIONAL EQUITY RESEARCH

Tata Consultancy Service (TCS IN)

Losing momentum; valuations to be capped

INDIA | IT SERVICES | Company Update

22 December 2015

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 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. It has missed consensus topline growth estimates for four consecutive quarters, leading to muted stock performance.

Difficult to grow on the large base, especially with persistent sector weakness

TCS is now a giant, in terms of its size. Its FY16 topline of US$ 16bn is in catching distance of Fortune 500 companies of the world (Wuhan Iron & Steel Group being the last with topline of US$ 18bn). For the company to grow in double digits on this base implies adding US$ 2bn revenues annually – a herculean task for any company. We believe the last four quarters of below-expectations growth are clear indications of the engine slowing down. Given the persistent weakness in telecom, retail and E&U verticals (25% of revenues for TCS), we expect the company to fail to achieve double-digit growth rate in FY17 and beyond.

Incremental revenue analysis alludes to decelerating growth

Over the last four quarters, TCS has added incremental revenues of only US$ 1.4bn (yoy) – much lower than the US$ 2bn it needs to add (and what it achieved in FY15), for double digit growth. While revenues have been impacted by cross-currency movements (290bps) – adjusted growth still falls short of target.

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

Over the last decade, TCS saw 22% CAGR in revenues, generating Rs 866bn of OCF – much higher than any other company in the sector. However, it paid out 50% of this cash as dividends, and 22% is sitting as cash/investments. It did not acquire any company of significant size/capability (apart from Alti in 2013 to gain access to the French market). 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 do the same.

While the management maintains that they have been building in-house delivery capabilities in the digital space, much ahead of others, we do not see this translating into significant deal-wins in the digital space. We believe that its failure to invest the cash generated in the last decade into growth opportunities for the future will hurt TCS badly. While it will still continue to grow in high single digits, we believe double digit growth in topline and earnings will elude the company for next 2-3 years.

Valuations to de-rate and come at par with Infosys

Currently, TCS is trading at 18x FY17 P/E, a 10% premium to Infosys. 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 by FY18. We see the growth and consistency premium (which TCS has commanded over the last three years over Infosys) vanishing over the next three years.

We have downgraded our FY17 estimates (-4%) based on lower topline growth than earlier anticipated. We now expect TCS to report 9.5% USD revenue growth in FY17 – behind Infosys and HCL Tech. We introduce FY18 estimates and roll forward our valuation to average of FY17-18 P/E. We downgrade our multiple to 18x (from 20x earlier) – at par with Infosys. Our price target of Rs 2550 (Rs 2800 earlier) offers 4% upside from current levels. We downgrade to NEUTRAL.

Downgrade to NEUTRAL

CMP RS 2445

TARGET RS 2550 (+4%)

COMPANY DATA

O/S SHARES (MN) :	1970
MARKET CAP (RSBN) :	4680
MARKET CAP (USDBN) :	69.9
52 - WK HI/LO (RS) :	2810 / 2317
LIQUIDITY 3M (USDMN) :	45.1
PAR VALUE (RS) :	1

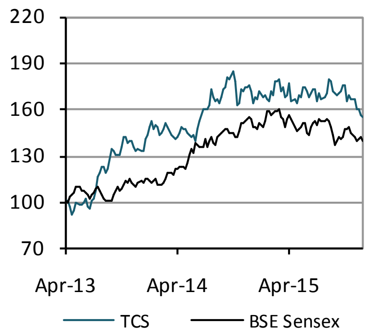
SHARE HOLDING PATTERN, %

	Sep 15	Jun 15	Mar 15
PROMOTERS :	73.9	73.9	73.9
FII / NRI :	16.8	16.9	17.1
FI / MF :	5.0	4.9	4.7
NON PRO :	0.9	0.8	0.8
PUBLIC & OTHERS :	3.6	3.7	3.6

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	-0.9	-6.6	0.5
REL TO BSE	0.2	-5.1	7.8

PRICE VS. SENSEX



Source: Phillip Capital India Research

KEY FINANCIALS

Rs bn	FY16E	FY17E	FY18E
Net Sales	1,091.6	1,200.3	1,304.7
EBIDTA	310.6	326.2	352.1
Net Profit	247.2	263.8	292.0
EPS, Rs	125.8	134.3	148.7
PER, x	19.4	18.2	16.4
EV/EBIDTA, x	15.3	14.4	13.3
P/BV, x	7.0	5.8	4.9
ROE, %	36.1	32.0	29.8

Source: PhillipCapital India Research Est.

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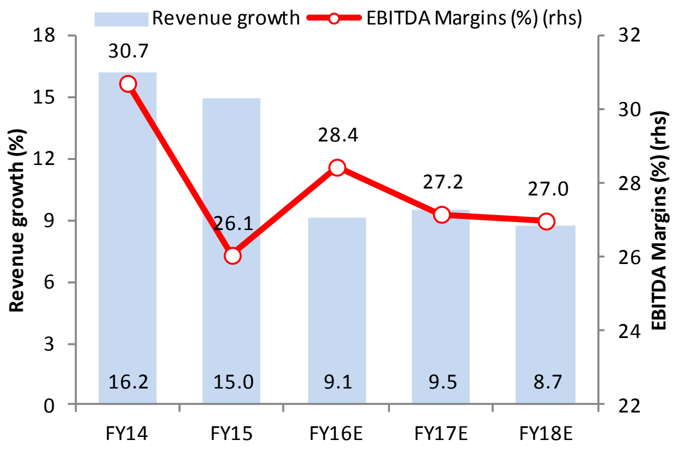
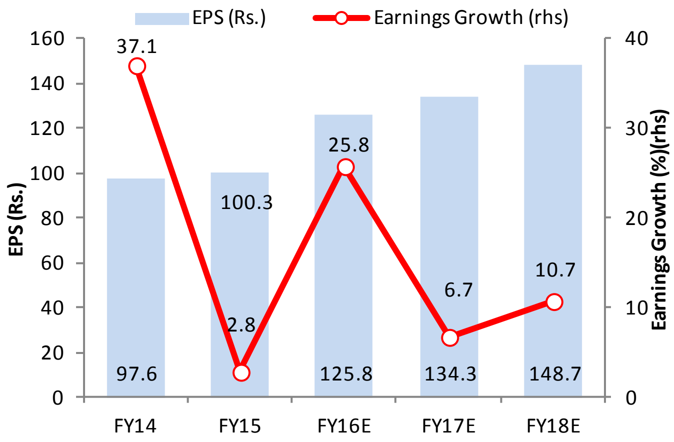
USD revenue growth (%) and EBITDA margins (%)



EPS (Rs) and earnings growth (%)



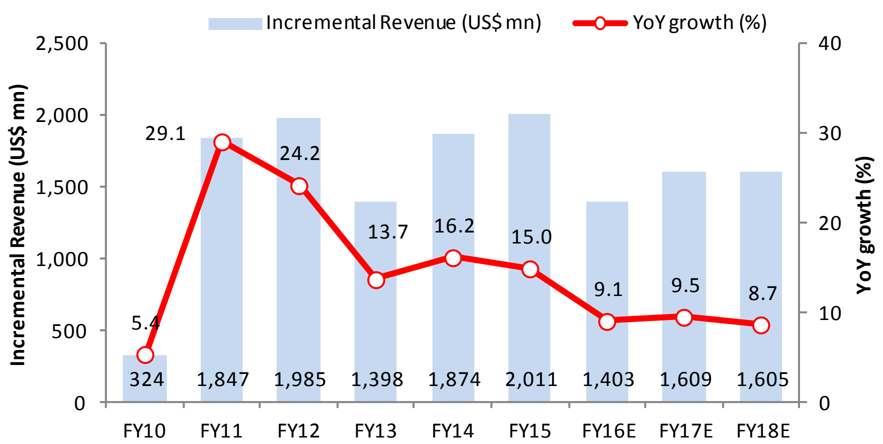
Source: Company, Phillip Capital India Research

Source and utilization of cash generated over the last decade

Revenue (Rs mn)	53,41,604	Dividend (Rs mn)	4,34,687	Dividend Payout Ratio	36.9
PAT (Rs mn)	11,78,821	CAPEX (Rs mn)	1,74,652	Dividend as % of OCF	50.2
OCF (Rs mn)	8,66,621	Cash Added (Rs mn)	1,95,216	Capex as % of OCF	20.2
FCF (Rs mn)	6,91,968	Acquisitions (Rs mn)	41,955	Acquisitions as % of OCF	4.8

Source: Company, Phillip Capital India Research

Incremental revenue for TCS – to peak out in FY15



Source: Company, Phillip Capital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Net sales	**946,484**	**1,091,588**	**1,200,337**	**1,304,693**
Growth, %	15.7	15.3	10.0	8.7
Employee expenses	-532,274	-592,186	-663,891	-730,853
Other Operating expenses	-167,548	-188,851	-210,272	-221,698
EBITDA (Core)	**246,662**	**310,551**	**326,174**	**352,143**
Growth, %	(1.9)	25.9	5.0	8.0
Margin, %	26.1	28.4	27.2	27.0
Depreciation	-18,698	-18,923	-20,097	-22,235
EBIT	**227,964**	**291,628**	**306,076**	**329,908**
Growth, %	(4.2)	27.9	5.0	7.8
Margin, %	24.1	26.7	25.5	25.3
Interest paid	0	0	0	0
Other Non-Operating Income	31,396	33,145	38,823	54,195
Pre-tax profit	**259,360**	**324,666**	**344,893**	**384,100**
Tax provided	-60,828	-75,737	-79,325	-90,264
Profit after tax	**198,532**	**248,929**	**265,568**	**293,837**
Others (Minorities, Associates)	-2,048	-1,772	-1,800	-1,800
Net Profit	**196,484**	**247,157**	**263,768**	**292,037**
Growth, %	2.8	25.8	6.7	10.7
Net Profit (adjusted)	**196,484**	**247,157**	**263,768**	**292,037**
Wtd avg shares (m)	1,959	1,964	1,964	1,964

US$ Revenues

	FY15	FY16E	FY17E	FY18E
US$ Revenue ($ mn)	**15,454**	**16,857**	**18,467**	**20,072**
Growth, %	15.0	9.1	9.5	8.7
Re / US$ (rate)	61.2	64.8	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Cash & bank	18,622	31,663	76,089	105,484
Marketable securities at cost	0	0	0	0
Debtors	204,399	241,320	260,680	290,378
Inventory	0	0	0	0
Other current assets	250,980	294,598	310,176	345,513
Total current assets	474,001	567,581	646,945	741,376
Investments	17,543	27,172	67,172	107,172
Net fixed assets	257,993	271,409	309,409	353,744
Non-current assets	0	0	0	0
Total assets	**749,537**	**866,162**	**1,023,525**	**1,202,291**
Total current liabilities	146,715	155,086	169,472	188,761
Non-current liabilities	18,919	23,226	24,406	27,082
Total liabilities	165,634	178,312	193,878	215,842
Paid-up capital	1,957	1,957	1,957	1,957
Reserves & surplus	572,810	682,414	822,411	977,413
Minorities	9,136	3,479	5,279	7,079
Shareholders' equity	583,903	687,850	829,648	986,449
Total equity & liabilities	**749,537**	**866,162**	**1,023,525**	**1,202,291**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Pre-tax profit	259,360	324,666	344,893	384,100
Depreciation	18,698	18,923	20,097	22,235
Chg in working capital	-15,057	-67,638	-19,373	-43,071
Total tax paid	-60,828	-75,737	-79,325	-90,264
Other operating activities	0	0	0	0
Cash flow from operating activities	**202,173**	**200,215**	**266,292**	**273,000**
Capital expenditure	-40,169	-32,339	-58,097	-66,570
Chg in investments	16,946	-9,629	-40,000	-40,000
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-23,223**	**-41,968**	**-98,097**	**-106,570**
Free cash flow	178,950	158,247	168,195	166,431
Equity raised/(repaid)	0	0	0	0
Debt raised/(repaid)	-130	-223	0	0
Dividend (incl. tax)	-181,042	-101,445	-123,770	-137,035
Other financing activities	5,973	-36,108	0	0
Cash flow from financing activities	**-175,016**	**-145,205**	**-123,770**	**-137,035**
Net chg in cash	3,934	13,041	44,425	29,396

Valuation Ratios

	FY15	FY16E	FY17E	FY18E
Per Share data				
EPS (INR)	100.3	125.8	134.3	148.7
Growth, %	2.8	25.5	6.7	10.7
Book NAV/share (INR)	293.4	348.5	419.7	498.7
CFPS (INR)	87.2	85.1	115.8	111.4
DPS (INR)	79.0	44.1	53.9	59.6
Return ratios				
Return on assets (%)	27.6	30.8	28.1	26.4
Return on equity (%)	34.2	36.1	32.0	29.8
Return on capital employed (%)	33.6	37.9	33.9	31.5
Turnover ratios				
Asset turnover (x)	1.8	1.9	1.8	1.8
Sales/Total assets (x)	1.3	1.4	1.3	1.2
Sales/Net FA (x)	3.8	4.1	4.1	3.9
Working capital/Sales (x)	0.3	0.3	0.3	0.3
Receivable days	78.8	80.7	79.3	81.2
Liquidity ratios				
Current ratio (x)	3.2	3.7	3.8	3.9
Quick ratio (x)	3.2	3.7	3.8	3.9
Dividend cover (x)	1.3	2.9	2.5	2.5
Total debt/Equity (%)	0.2	0.1	0.1	0.1
Net debt/Equity (%)	(3.0)	(4.5)	(9.1)	(10.7)
Valuation				
PER (x)	24.4	19.4	18.2	16.4
PEG (x) - y-o-y growth	8.6	0.8	2.7	1.5
Price/Book (x)	8.3	7.0	5.8	4.9
Yield (%)	3.2	1.8	2.2	2.4
EV/Net sales (x)	5.0	4.4	3.9	3.6
EV/EBITDA (x)	19.3	15.3	14.4	13.3
EV/EBIT (x)	20.9	16.3	15.4	14.2

PhillipCapital

HCL Technologies (HCLT IN)

Growth engine missing; valuations to be capped

INDIA | IT SERVICES | Company Update

22 December 2015

Cannibalization of IMS revenues by cloud platform poses a big threat

The biggest concern for HCL Tech has been the expected cannibalization 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 now expanding that 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 45% of the US$ 3.7bn incremental revenues that HCL has generated over FY09-15.

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 the 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 was compensated by higher revenues from new deals. However, with cloud platforms cannibalizing 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 few and far in between. As a result, HCL has reported CQGR of only 3% in IMS over the last four quarters, as opposed to 4% over the preceding four.

Margins to remain under pressure; higher depreciation adds further strain

Management expects margins to decline to 21-22% (EBIT) over the next two years as the company invests in building delivery capabilities in the digital space. While that is largely factored in the current price, we note that depreciation has risen by 30% over the last four quarters. While this might be because of the company taking on clients' assets in its IMS deals, negative impact on margins remains significant.

Growth in enterprise business still eludes, despite 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 the twelve quarters in FY12-14 period. 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 spawned doubts over the sustainability of the bundling strategy and the accompanied growth in EA.

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

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 – to gain access to the European market. Even now, when companies like Infosys and Mindtree are looking to make amends, by acquiring small niche companies in the digital space – we find HCL reluctant to do the same.

Little scope for rerating; not much downside either

Currently HCL is trading at 14x FY17 P/E – at a discount to TCS and Infosys, but at par with Wipro. We do not see any rerating potential given inferior revenue and margin profile expected over the next two years due to cannibalization of revenues by cloud platforms. However, with ROE at 25%, we do not see significant downside either. We have downgraded our FY17 estimates (-4%) based on lower topline growth than earlier anticipated.

We introduce FY18 estimates and roll forward our valuation to average of FY17-18 P/E. We downgrade our multiple to 14x (from 16x earlier) – at a premium to Wipro and TechM. Our price target of Rs 900 (Rs 1000 earlier) offers 5% upside from current levels. We downgrade to NEUTRAL.

Downgrade to NEUTRAL

CMP RS 856

TARGET RS 900 (+5%)

COMPANY DATA

O/S SHARES (MN) :	1409
MARKET CAP (RSBN) :	1190
MARKET CAP (USDBN) :	17.8
52 - WK HI/LO (RS) :	1058 / 725
LIQUIDITY 3M (USDMN) :	28.5
PAR VALUE (RS) :	2

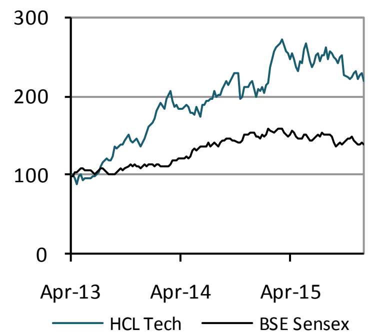
SHARE HOLDING PATTERN, %

	Sep 15	Jun 15	Mar 15
PROMOTERS :	60.6	60.6	60.6
FII / NRI :	29.1	29.6	30.3
FI / MF :	4.9	4.5	3.7
NON PRO :	1.2	1.2	1.4
PUBLIC & OTHERS :	4.9	4.8	4.8

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	0.2	-9.1	13.7
REL TO BSE	1.4	-7.6	21.0

PRICE VS. SENSEX



Source: Phillip Capital India Research

KEY FINANCIALS

Rs mn	FY16E	FY17E	FY18E
Net Sales	429.2	476.5	524.2
EBIDTA	94.4	105.7	116.3
Net Profit	74.5	85.0	94.6
EPS, Rs	52.7	60.1	67.0
PER, x	16.2	14.2	12.8
EV/EBIDTA, x	11.5	10.0	8.7
P/BV, x	4.2	3.6	3.1
ROE, %	25.9	25.2	24.2

Source: PhillipCapital India Research Est.

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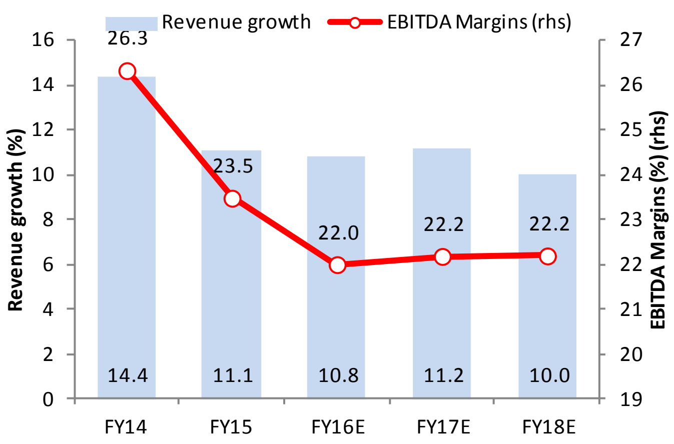
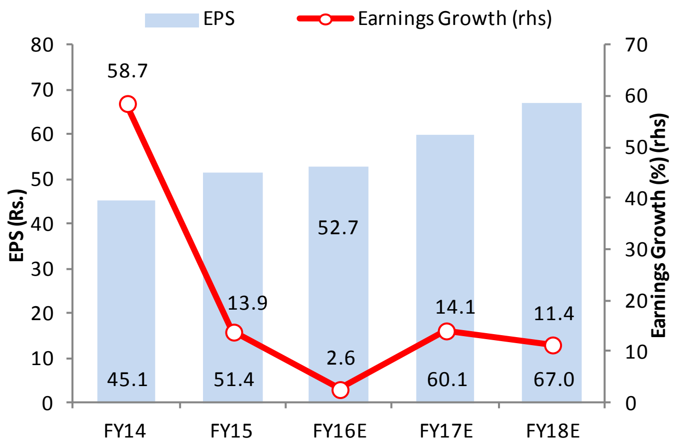
USD revenue growth (%) and EBITDA margins (%)



EPS (Rs) and earnings growth (%)



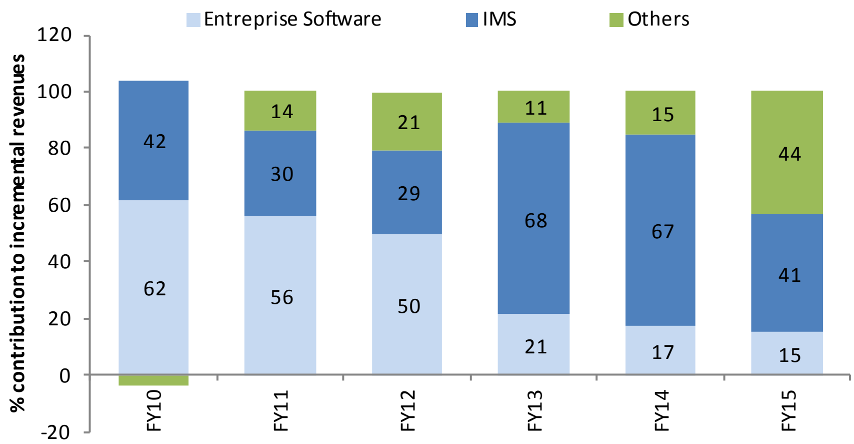
Source: Company, Phillip Capital India Research

Source and utilization of cash generated over the last decade

Revenue (Rs mn)	17,38,637	Dividend (Rs mn)	90,833	Dividend Payout Ratio	33.8
PAT (Rs mn)	2,68,524	CAPEX (Rs mn)	67,693	Dividend as % of OCF	33.8
OCF (Rs mn)	2,68,958	Cash Added (Rs mn)	97,991	Capex as % of OCF	25.2
FCF (Rs mn)	3,24,332	Acquisitions (Rs mn)	37,846	Acquisitions as % of OCF	14.1

Source: Company, Phillip Capital India Research

Share of Enterprise business in incremental revenues has been constantly declining



Source: Company, Phillip Capital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Net sales	**370,620**	**429,188**	**476,510**	**524,193**
Growth, %	13	16	11	10
Employee expenses	-237,970	-281,511	-314,833	-347,359
Other Operating expenses	-45,630	-53,268	-55,985	-60,505
EBITDA (Core)	**87,020**	**94,410**	**105,693**	**116,328**
Growth, %	0.4	8.5	12.0	10.1
Margin, %	23.5	22.0	22.2	22.2
Depreciation	-4,510	-5,649	-5,930	-6,594
EBIT	**82,510**	**88,761**	**99,763**	**109,734**
Growth, %	4.0	7.6	12.4	10.0
Margin, %	22.3	20.7	20.9	20.9
Other Non-Operating Income	9,320	5,854	8,486	10,829
Forex Gains\ (Losses)	-200	448	0	0
Pre-tax profit	**91,630**	**95,063**	**108,248**	**120,563**
Tax provided	-19,080	-20,606	-23,273	-25,921
Profit after tax	**72,550**	**74,458**	**84,975**	**94,642**
Non Recurring Item	0	0	0	0
Net Profit	**72,550**	**74,458**	**84,975**	**94,642**
Growth, %	13.9	2.6	14.1	11.4
Net Profit (adjusted)	**72,550**	**74,458**	**84,975**	**94,642**
Wtd avg shares (m)	1,411	1,413	1,413	1,413

US$ Revenues

	FY15	FY16E	FY17E	FY18E
US$ Revenue ($ mn)	**5,953**	**6,594**	**7,331**	**8,065**
Growth, %	11.1	10.8	11.2	10.0
Re / US$ (rate)	62.3	65.1	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Cash & bank	13,520	14,436	23,937	40,851
Marketable securities at cost	104,370	123,542	143,542	163,542
Debtors	94,860	107,003	118,801	130,689
Inventory	0	0	0	0
Other current assets	23,380	30,622	33,764	37,308
Total current assets	236,130	275,603	320,043	372,391
Investments	80	103	603	603
Net fixed assets	120,900	136,884	152,634	168,365
Non-current assets	0	0	0	0
Total assets	**357,110**	**412,590**	**473,280**	**541,359**
Total current liabilities	92,320	111,833	125,071	137,992
Non-current liabilities	17,280	12,986	11,658	11,658
Total liabilities	109,600	124,819	136,729	149,650
Paid-up capital	1,341	1,341	1,341	1,341
Reserves & surplus	246,170	286,430	335,211	390,368
Minorities	0	0	0	0
Shareholders' equity	247,510	287,771	336,552	391,709
Total equity & liabilities	**357,110**	**412,590**	**473,280**	**541,359**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Pre-tax profit	91,630	95,063	108,248	120,563
Depreciation	4,510	5,649	5,930	6,594
Chg in working capital	-9,555	128	-1,702	-2,511
Total tax paid	-19,080	-20,606	-23,273	-25,921
Other operating activities	0	0	0	0
Cash flow from operating activities	**67,505**	**80,234**	**89,203**	**98,725**
Capital expenditure	-18,991	-21,633	-21,680	-22,325
Chg in investments	76	-23	-500	0
Chg in marketable securities	-14,578	-19,172	-20,000	-20,000
Other investing activities	0	0	0	0
Cash flow from investing activities	**-33,493**	**-40,828**	**-42,180**	**-42,325**
Free cash flow	34,012	39,407	47,023	56,400
Equity raised/(repaid)	0	0	0	0
Debt raised/(repaid)	-4,844	-4,294	-1,328	0
Dividend (incl. tax)	-37,773	-36,192	-36,194	-39,485
Other financing activities	11,919	1,995	0	0
Cash flow from financing activities	**-30,698**	**-38,491**	**-37,522**	**-39,485**
Net chg in cash	3,314	916	9,501	16,915

Valuation Ratios

	FY15	FY16E	FY17E	FY18E
Per Share data				
EPS (INR)	51.4	52.7	60.1	67.0
Growth, %	14.1	2.5	14.1	11.4
Book NAV/share (INR)	175.4	203.7	238.2	277.3
CFPS (INR)	41.2	52.6	57.1	62.2
DPS (INR)	22.9	21.9	21.9	23.9
Return ratios				
Return on assets (%)	21.9	19.3	19.2	18.7
Return on equity (%)	29.3	25.9	25.2	24.2
Return on capital employed (%)	29.8	26.3	26.2	25.2
Turnover ratios				
Asset turnover (x)	2.7	2.8	2.8	2.8
Sales/Total assets (x)	1.1	1.1	1.1	1.0
Sales/Net FA (x)	3.3	3.3	3.3	3.3
Working capital/Sales (x)	0.1	0.1	0.1	0.1
Receivable days	93.4	91.0	91.0	91.0
Liquidity ratios				
Current ratio (x)	2.6	2.5	2.6	2.7
Quick ratio (x)	2.6	2.5	2.6	2.7
Dividend cover (x)	2.2	2.4	2.7	2.8
Total debt/Equity (%)	7.0	4.5	3.5	3.0
Net debt/Equity (%)	1.5	(0.5)	(3.6)	(7.5)
Valuation				
PER (x)	16.6	16.2	14.2	12.8
PEG (x) - y-o-y growth	1.2	6.5	1.0	1.1
Price/Book (x)	4.9	4.2	3.6	3.1
Yield (%)	2.7	2.6	2.6	2.8
EV/Net sales (x)	3.0	2.5	2.2	1.9
EV/EBITDA (x)	12.7	11.5	10.0	8.7
EV/EBIT (x)	13.4	12.2	10.6	9.3

Wipro (WPRO IN)

Turnaround nowhere in sight

INDIA | IT SERVICES | Company Update

22 December 2015

Subpar growth despite robust deal-wins

Over the last six 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 (US$ 3bn as compared to US$ 1.55bn in FY14 – *announced large deals*) led to the belief that it was finally turning the corner. However, while deal-wins have been robust over the last six quarters, this has not translated into revenue growth primarily because it continues to lose large part of its existing business to competitors. In FY16, we expect Wipro to report 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 expect the company to lag its peers.

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 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 reported 0% CAGR over the last 10 years against 17% and 16% for TCS and HCL Tech.

Exposure to E&U vertical – plain unlucky

Wipro's fortunes are a glaring manifestation of the saying – 'when one thing goes wrong, everything else also does'. While Wipro was struggling to catch up with competition, an unprecedented fall in energy prices meant most of the E&U clients postponed their IT spending. Wipro has the highest exposure to the segment (15% of revenues), which has had a significant impact on its growth over the last four quarters.

Another round of management reshuffle likely – to further delay revival

The tenure of Wipro's current CEO, TK Kurien, expires in January-2016. We see little likelihood of the tenure being extended. Wipro's hiring of Abid Neemuchwala (from TCS) as COO appears to be the precursor to another round of management reshuffle. While this could be positive for the long term, it will only further delay the company's turnaround.

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

Over the last 10 years, Wipro generated Rs 434bn of OCF and paid out 33% of this cash as dividends while 36% sits as cash/investments. While it spent much higher share of cash on acquisitions; most of the acquisitions were in the traditional IT services space, and were more to acquire customers, than delivery capabilities. Even now, when companies like Infosys and Mindtree are looking to make amends by acquiring small niche companies in the digital space, we find Wipro continues to acquire companies like Celent, a provider of ADM and IMS services.

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

Currently, Wipro is trading at 14x 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, it will still report superior growth and returns over the next three years than Wipro. We see no reason for Wipro to trade at par with HCL Tech and expect the stock to be de-rated from current levels (along with the entire IT sector, excluding few companies such as Infosys).

We have downgraded our FY17 estimates (-3%) based on lower topline growth than earlier anticipated. We introduce FY18 estimates and roll forward our valuation to average of FY17-18 P/E. We downgrade our multiple to 12x (from 14x earlier) – lowest in our top-4 coverage universe and in line with TechM. Our price target of Rs 490 (Rs 550 earlier) offers 13% downside from current levels. We downgrade to SELL.

Downgrade to SELL

CMP RS 557

TARGET RS 490 (-13%)

COMPANY DATA

O/S SHARES (MN) :	2470
MARKET CAP (RSBN) :	1380
MARKET CAP (USDBN) :	20.6
52 - WK HI/LO (RS) :	677 / 513
LIQUIDITY 3M (USDMN) :	12.6
PAR VALUE (RS) :	2

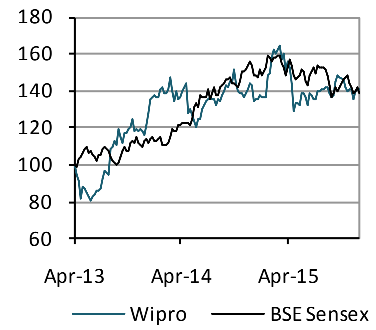
SHARE HOLDING PATTERN, %

	Sep 15	Jun 15	Mar 15
PROMOTERS :	73.4	73.4	73.4
FII / NRI :	10.7	10.3	10.7
FI / MF :	4.6	4.9	4.4
NON PRO :	4.9	4.9	4.9
PUBLIC & OTHERS :	6.5	6.6	6.7

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	1.3	-2.0	3.1
REL TO BSE	2.4	-0.5	10.5

PRICE VS. SENSEX



Source: Phillip Capital India Research

KEY FINANCIALS

Rs bn	FY16E	FY17E	FY18E
Net Sales	509.2	542.8	577.6
EBIDTA	110.8	111.6	118.7
Net Profit	91.4	95.6	103.8
EPS, Rs	37.1	38.8	42.2
PER, x	15.0	14.3	13.2
EV/EBIDTA, x	10.7	10.3	9.3
P/BV, x	2.9	2.6	2.3
ROE, %	19.6	18.1	17.4

Source: PhillipCapital India Research Est.

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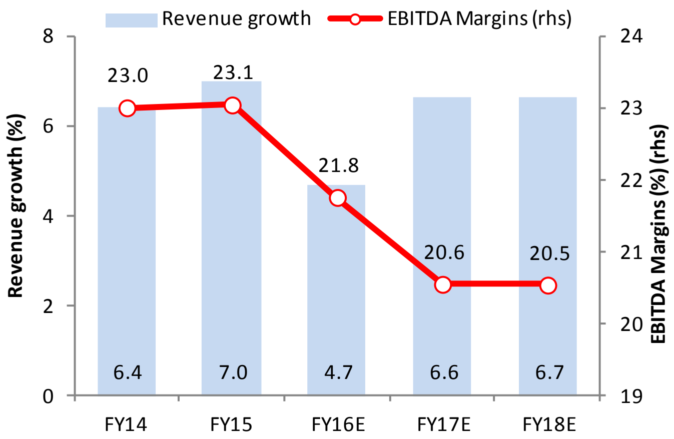
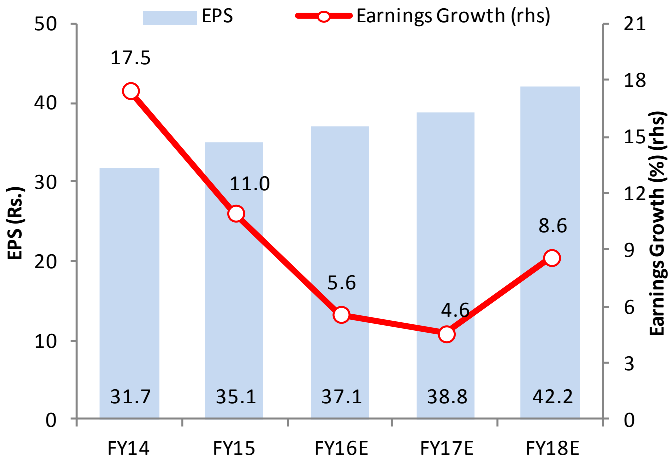
USD revenue growth (%) and EBITDA margins (%)



EPS (Rs) and earnings growth (%)



Source: Company, Phillip Capital India Research

Source and utilization of cash generated over the last decade

Revenue (Rs mn)	28,87,561	Dividend (Rs mn)	1,42,558	Dividend Payout Ratio	28.7
PAT (Rs mn)	4,97,271	CAPEX (Rs mn)	1,04,468	Dividend as % of OCF	32.8
OCF (Rs mn)	4,34,505	Cash Added (Rs mn)	1,55,643	Capex as % of OCF	24.0
FCF (Rs mn)	3,24,332	Acquisitions (Rs mn)	74,114	Acquisitions as % of OCF	17.1

Source: Company, Phillip Capital India Research

Early starter in both IMS and ERD domains, Wipro has squandered the advantage

ERD (US$ mn)	FY10	FY11	FY12	FY13	FY14	FY15	CAGR	% of Revs
TCS	318	395	473	535	632	699	17%	5%
Infosys	106	146	238	246	270	298	23%	3%
HCL Tech	510	644	774	821	881	1,087	16%	18%
Wipro	694	726	734	689	673	694	0%	10%
Total top-4	**1,629**	**1,911**	**2,219**	**2,291**	**2,456**	**2,779**	**11%**	**7%**
IMS (US$ mn)	**FY10**	**FY11**	**FY12**	**FY13**	**FY14**	**FY15**	**CAGR**	**% of Revs**
TCS	530	774	1,021	1,327	1,603	2,135	32%	14%
Infosys	345	379	420	509	584	699	15%	8%
HCL Tech	572	827	1,006	1,367	1,819	2,064	29%	35%
Wipro	927	1,111	1,305	1,465	1,590	1,893	15%	27%
Total top-4	**2,374**	**3,092**	**3,751**	**4,668**	**5,597**	**6,792**	**23%**	**18%**

Source: Company, Phillip Capital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18e
Net sales	**469,545**	**509,227**	**542,755**	**577,586**
Growth, %	8.1	8.5	6.6	6.4
Employee expenses	-308,460	-336,574	-350,249	-371,406
Other Operating expenses	-52,840	-61,817	-80,942	-87,518
EBITDA (Core)	**108,245**	**110,836**	**111,564**	**118,662**
Growth, %	8.3	2.4	0.7	6.4
Margin, %	23.1	21.8	20.6	20.5
Depreciation	-12,823	-13,359	-14,500	-15,309
EBIT	**95,422**	**97,477**	**97,064**	**103,353**
Growth, %	6.8	2.2	(0.4)	6.5
Margin, %	20.3	19.1	17.9	17.9
Interest paid	0	0	0	0
Other Non-Operating Income	16,260	19,982	25,732	30,030
Pre-tax profit	**111,682**	**117,459**	**122,796**	**133,384**
Tax provided	-24,624	-25,760	-27,015	-29,344
Profit after tax	**87,058**	**91,699**	**95,781**	**104,039**
Others (Minorities, Associates)	-531	-324	-231	-251
Net Profit	**86,527**	**91,375**	**95,550**	**103,788**
Growth, %	11.0	5.6	4.6	8.6
Net Profit (adjusted)	**86,527**	**91,375**	**95,550**	**103,788**
Wtd avg shares (m)	2,466	2,461	2,461	2,461

US$ Revenues

	FY15	FY16E	FY17E	FY18E
US$ Revenue ($ mn)	**7,082**	**7,413**	**7,905**	**8,432**
Growth, %	7.0	4.7	6.6	6.7
Re / US$ (rate)	62.2	65.1	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18e
Cash & bank	158,940	195,601	235,714	284,423
Marketable securities at cost	53,908	53,908	53,908	53,908
Debtors	91,531	100,450	107,064	113,935
Inventory	4,849	2,372	2,379	2,532
Other current assets	127,264	109,693	116,373	123,841
Total current assets	436,492	462,024	515,438	578,638
Investments	0	0	0	0
Net fixed assets	130,215	141,783	150,183	157,774
Non-current assets	33,326	34,627	36,907	39,276
Total assets	**600,033**	**638,434**	**702,528**	**775,688**
Total current liabilities	164,029	144,225	145,557	150,339
Non-current liabilities	26,376	24,955	25,473	26,242
Total liabilities	190,405	169,179	171,030	176,581
Paid-up capital	4,937	4,937	4,937	4,937
Reserves & surplus	403,045	462,348	524,360	591,719
Minorities	1,646	1,970	2,201	2,451
Shareholders' equity	409,628	469,255	531,498	599,107
Total equity & liabilities	**600,033**	**638,434**	**702,528**	**775,688**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18e
Pre-tax profit	111,682	117,459	122,796	133,384
Depreciation	12,823	13,359	14,500	15,309
Chg in working capital	-18,658	-9,977	-14,249	-12,078
Total tax paid	-24,624	-25,760	-27,015	-29,344
Other operating activities	0	0	0	0
Cash flow from operating activities	**81,223**	**95,081**	**96,032**	**107,270**
Capital expenditure	-26,231	-24,927	-22,900	-22,900
Chg in investments	0	0	0	0
Chg in marketable securities	6,649	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-19,582**	**-24,927**	**-22,900**	**-22,900**
Free cash flow	61,641	70,154	73,132	84,370
Equity raised/(repaid)	7,187	0	0	0
Debt raised/(repaid)	5,414	-1,421	519	769
Dividend (incl. tax)	-34,565	-32,072	-33,538	-36,430
Other financing activities	5,334	0	0	0
Cash flow from financing activities	**-16,902**	**-33,493**	**-33,020**	**-35,661**
Net chg in cash	44,739	36,661	40,113	48,709

Valuation Ratios

	FY15	FY16E	FY17E	FY18e
Per Share data				
EPS (INR)	35.1	37.1	38.8	42.2
Growth, %	10.8	5.8	4.6	8.6
Book NAV/share (INR)	165.4	189.9	215.1	242.5
CFPS (INR)	17.0	41.0	29.9	32.8
DPS (INR)	12.0	11.1	11.6	12.7
Return ratios				
Return on assets (%)	15.8	14.8	14.3	14.1
Return on equity (%)	21.2	19.6	18.1	17.4
Return on capital employed (%)	21.7	19.7	18.2	17.6
Turnover ratios				
Asset turnover (x)	2.1	2.0	2.1	2.1
Sales/Total assets (x)	0.9	0.8	0.8	0.8
Sales/Net FA (x)	3.8	3.7	3.7	3.8
Receivable days	71.2	72.0	72.0	72.0
Inventory days	3.8	1.7	1.6	1.6
Liquidity ratios				
Current ratio (x)	2.7	3.2	3.5	3.8
Quick ratio (x)	2.6	3.2	3.5	3.8
Dividend cover (x)	2.9	3.3	3.3	3.3
Total debt/Equity (%)	22.7	14.3	12.5	11.1
Net debt/Equity (%)	(16.3)	(27.6)	(32.0)	(36.6)
Valuation				
PER (x)	15.9	15.0	14.3	13.2
PEG (x) - y-o-y growth	1.5	2.6	3.1	1.5
Price/Book (x)	3.4	2.9	2.6	2.3
Yield (%)	2.2	2.0	2.1	2.3
EV/Net sales (x)	2.7	2.3	2.1	1.9
EV/EBITDA (x)	11.6	10.7	10.3	9.3
EV/EBIT (x)	13.1	12.2	11.8	10.6

INSTITUTIONAL EQUITY RESEARCH

Tech Mahindra (TECHM IN)

Back to where it started from ...

INDIA | IT SERVICES | Company Update

22 December 2015

Back to where it started from

After its acquisition of Satyam, Tech Mahindra saw a sharp and significant rerating – from 10x (pre-FY13) to peak multiple of 17x in FY15. The underlying argument was that Satyam acquisition helped it transform from a telecom player (95% of revenues) to a diversified one, with significant scope for margin expansion. Its strong foothold in Europe also lent support to its growth expectations.

However, we believe its badly managed acquisition of LCC has undone its efforts in the last three years. After LCC, communications now forms over 53% of its revenues, leading to significant revenue concentration in one domain. Its margins are down to ~16% from the 20-21%. Deal-wins and growth in other verticals such as retail and manufacturing have also been tepid. It now resembles a 'typical' midcap company, with strong concentration of one vertical and margins below 15%.

Deceleration in telecom leads to growth concerns gaining credence

Adjusting for the LCC and Sofgen acquisition, TechM is likely to report USD revenue growth of only 2.5% in FY16. Even adjusting for CC impact, growth in constant currency is not likely to be more than 5%. This casts deep shadows on its growth potential for FY17 and beyond.

Almost all its peers have been alluding to significant slowdown in their telecom businesses for the last several quarters. While TechM had managed to buck the trend until date, its management too signalled deceleration in the vertical in their 2QFY16 call. We believe deceleration in telecom will be difficult for the company to mitigate by growth in other verticals where it does not have significant presence.

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. LCC was reported to have 8% EBITDA margins on acquisition, which were expected to grow to double digits on higher offshoring. However, difficulties in integration meant that LCC's margins have slipped to 2-3% with no revival in sight. We do not expect LCC's margins, and hence TechM's margins to revive before FY17.

Better acquisition history than peers – though not an apple-apple comparison

Unlike its peers, the company has a strong acquisition history – with the likes of Satyam, LCC, and Sofgen. It spent Rs 46bn (50% of the OCF generated over the last ten years) on acquisitions. However, all these acquisitions can be attributed to acquiring customer/size and not to acquiring capabilities, which can later be leveraged to mitigate competition and secure superior growth.

No reason to trade at par with top-4, further de-rating on the cards

Currently TechM is trading at 16x FY17 P/E – premium to both HCL Tech and Wipro. We see no reason for TechM NOW, to trade at multiple in line with the top-4. Its profile resembles a 'large midcap' company, and we expect further de-rating to take its multiple in line with some of the better managed midcap IT stocks. Despite the near certainty of the company reporting only 5% organic growth in FY16, consensus estimates point to more than 15% growth expectations in FY17 – we expect significant cut in FY17 consensus estimates leading to further pressure on the stock.

We have downgraded our FY17 estimates (-9%) based on lower topline growth than earlier anticipated. We introduce FY18 estimates and roll forward our valuation to average of FY17-18 P/E. We downgrade our multiple to 12x (from 15x earlier) – lowest in our top-5 coverage universe and in-line with Wipro. Our price target of Rs 420 (Rs 540 earlier) offers 20% downside from current levels. We downgrade to SELL.

Downgrade to SELL

CMP RS 522

TARGET RS 420 (-20%)

COMPANY DATA

O/S SHARES (MN) :	967
MARKET CAP (RSBN) :	503
MARKET CAP (USDBN) :	7.5
52 - WK HI/LO (RS) :	750 / 459
LIQUIDITY 3M (USDMN) :	12.2
PAR VALUE (RS) :	5

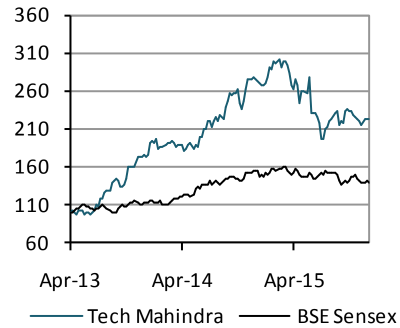
SHARE HOLDING PATTERN, %

	Sep 15	Jun 15	Mar 15
PROMOTERS :	36.7	36.7	36.7
FII / NRI :	39.0	39.2	39.3
FI / MF :	11.8	10.9	10.2
NON PRO :	3.4	3.7	3.8
PUBLIC & OTHERS :	10.9	11.5	11.6

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	0.1	-3.9	-16.7
REL TO BSE	1.2	-2.4	-9.3

PRICE VS. SENSEX



Source: Phillip Capital India Research

KEY FINANCIALS

Rs bn	FY16E	FY17E	FY18E
Net Sales	267.3	290.9	317.1
EBIDTA	42.6	48.3	53.2
Net Profit	28.7	31.4	35.8
EPS, Rs	29.8	32.6	37.2
PER, x	17.5	16.0	14.0
EV/EBIDTA, x	11.2	9.4	8.1
P/BV, x	3.2	2.8	2.4
ROE, %	18.3	17.4	17.2

Source: PhillipCapital India Research Est.

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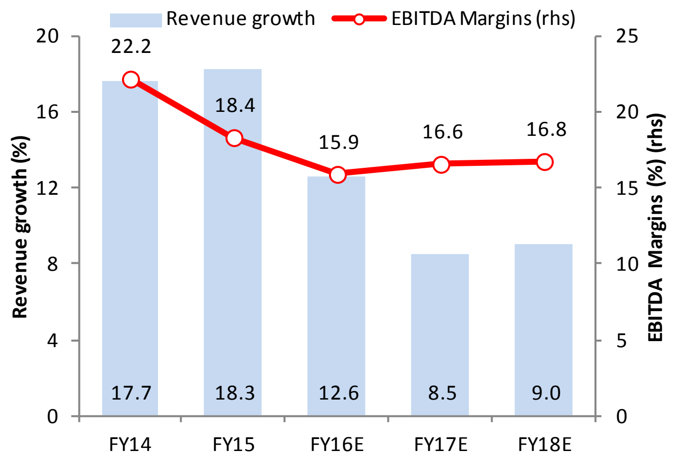
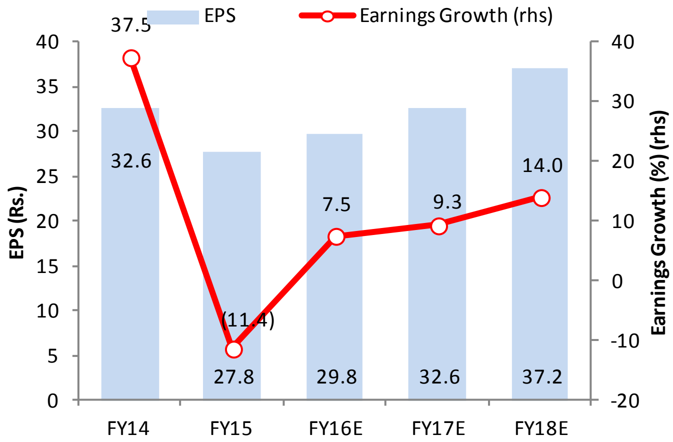
USD revenue growth (%) and EBITDA margins (%)

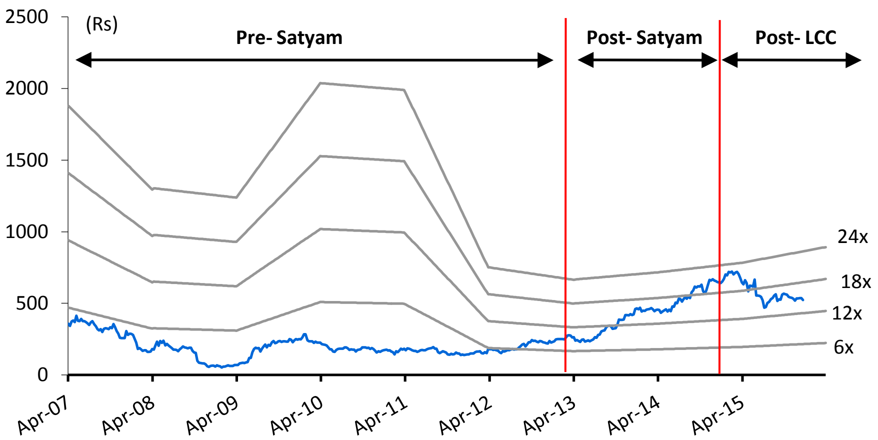


EPS (Rs) and earnings growth (%)

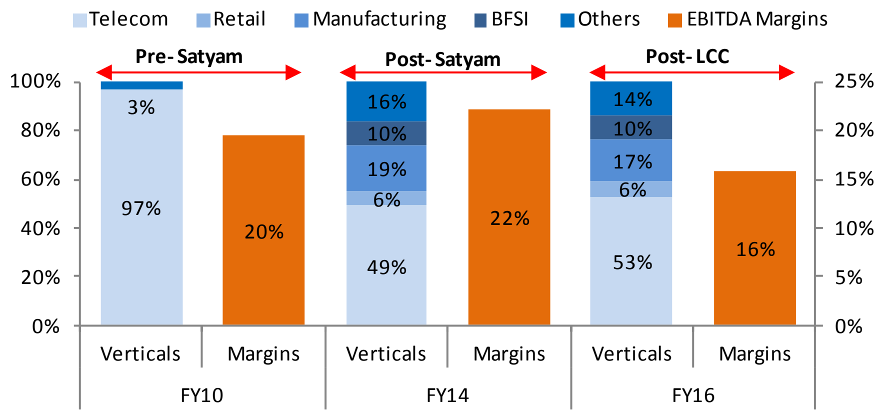


Source: Company, Phillip Capital India Research

TechM multiple evolution – rerating post Satyam and derating post LCC



TechM profile evolution – post Satyam and post LCC



Source: Company, Phillip Capital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Net sales	**226,213**	**267,312**	**290,936**	**317,100**
Growth, %	20.1	18.2	8.8	9.0
Employee expenses	-151,578	-184,435	-198,691	-219,561
Other Operating expenses	-33,107	-40,277	-43,948	-44,324
EBITDA (Core)	**41,528**	**42,599**	**48,296**	**53,215**
Growth, %	(0.7)	2.6	13.4	10.2
Margin, %	18.4	15.9	16.6	16.8
Depreciation	-6,114	-7,479	-8,517	-9,489
EBIT	**35,414**	**35,120**	**39,779**	**43,725**
Growth, %	(3.3)	(0.8)	13.3	9.9
Margin, %	15.7	13.1	13.7	13.8
Interest paid	-299	-640	-506	-506
Other Non-Operating Income	1,065	4,129	3,516	5,575
Pre-tax profit	**36,180**	**38,609**	**42,790**	**48,794**
Tax provided	-9,596	-9,701	-11,125	-12,687
Profit after tax	**26,584**	**28,909**	**31,664**	**36,108**
Others (Minorities, Associates)	-309	-183	-262	-298
Net Profit	**26,275**	**28,726**	**31,403**	**35,810**
Growth, %	(9.7)	9.3	9.3	14.0
Net Profit (adjusted)	**26,275**	**28,726**	**31,403**	**35,810**
Wtd avg shares (m)	947	962	963	963

US$ Revenues

	FY15	FY16E	FY17E	FY18E
US$ Revenue ($ mn)	**3,664**	**4,126**	**4,476**	**4,878**
Growth, %	18.3	12.6	8.5	9.0
Re / US$ (rate)	61.7	64.8	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Cash & bank	24,049	31,187	54,580	80,022
Debtors	52,059	76,898	79,708	86,877
Inventory	245	366	399	434
Other current assets	19,404	13,182	14,348	15,638
Total current assets	127,240	158,252	188,889	226,409
Investments	21,334	21,334	21,334	21,334
Gross fixed assets	65,363	74,363	83,363	92,363
Less: Depreciation	-25,034	-32,513	-41,031	-50,520
Add: Capital WIP	5,677	5,677	5,677	5,677
Net fixed assets	46,006	47,527	48,009	47,520
Total assets	**198,481**	**231,013**	**262,133**	**299,164**
Current liabilities	32,813	40,424	43,549	48,123
Provisions	22,088	24,859	28,511	32,745
Total current liabilities	54,901	65,284	72,060	80,867
Non-current liabilities	7,186	7,186	7,186	7,186
Total liabilities	62,087	72,470	79,246	88,053
Paid-up capital	4,804	4,804	4,804	4,804
Reserves & surplus	129,989	151,956	176,038	203,963
Minorities	1,601	1,784	2,046	2,344
Shareholders' equity	136,394	158,544	182,887	211,111
Total equity & liabilities	**198,481**	**231,013**	**262,133**	**299,164**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Pre-tax profit	36,180	38,609	42,790	48,794
Depreciation	6,114	7,479	8,517	9,489
Chg in working capital	-27,559	-16,262	-4,120	-7,504
Total tax paid	-4,386	-6,929	-7,474	-8,453
Other operating activities	0	0	0	0
Cash flow from operating activities	**10,349**	**22,897**	**39,714**	**42,326**
Capital expenditure	-23,514	-9,000	-9,000	-9,000
Chg in investments	-6,405	0	0	0
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-29,919**	**-9,000**	**-9,000**	**-9,000**
Free cash flow	-19,570	13,897	30,714	33,326
Equity raised/(repaid)	2,457	-3	0	0
Debt raised/(repaid)	6,222	0	0	0
Dividend (incl. tax)	-6,645	-6,756	-7,321	-7,884
Other financing activities	8,581	0	0	0
Cash flow from financing activities	**10,470**	**-6,759**	**-7,321**	**-7,884**
Net chg in cash	-9,100	7,138	23,393	25,442

Valuation Ratios

	FY15	FY16E	FY17E	FY18E
Per Share data				
EPS (INR)	27.8	29.8	32.6	37.2
Growth, %	(11.4)	7.5	9.3	14.0
Book NAV/share (INR)	142.4	162.9	187.9	216.9
CFPS (INR)	9.8	19.5	37.6	38.2
DPS (INR)	6.0	6.0	6.5	7.0
Return ratios				
Return on assets (%)	15.0	13.7	13.0	13.0
Return on equity (%)	19.5	18.3	17.4	17.2
Return on capital employed (%)	21.1	19.0	18.0	17.8
Turnover ratios				
Asset turnover (x)	2.4	2.1	2.1	2.2
Sales/Total assets (x)	1.3	1.2	1.2	1.1
Sales/Net FA (x)	6.1	5.7	6.1	6.6
Working capital/Sales (x)	0.2	0.2	0.2	0.2
Receivable days	84.0	105.0	100.0	100.0
Liquidity ratios				
Current ratio (x)	2.3	2.4	2.6	2.8
Quick ratio (x)	2.3	2.4	2.6	2.8
Dividend cover (x)	4.6	5.0	5.0	5.3
Total debt/Equity (x)	0.1	0.0	0.0	0.0
Net debt/Equity (x)	(0.1)	(0.2)	(0.3)	(0.4)
Valuation				
PER (x)	18.8	17.5	16.0	14.0
PEG (x) - y-o-y growth	(1.7)	2.3	1.7	1.0
Price/Book (x)	3.7	3.2	2.8	2.4
Yield (%)	1.1	1.1	1.2	1.3
EV/Net sales (x)	2.1	1.8	1.6	1.4
EV/EBITDA (x)	11.5	11.2	9.4	8.1
EV/EBIT (x)	13.5	13.6	11.4	9.8

PhillipCapital

Mindtree (MTCL IN)

Another large cap in the making ...

INDIA | IT SERVICES | Company Update

22 December 2015

Breaking into the big league

Mindtree (MTCL) is on its way to becoming a large IT-services company — this is visible in its strategy of focusing on multiple segments through expertise-driven client engagements and the alignment of its portfolio to growth areas, such as digital and product engineering. The successful migration of a company from mid-cap to large-cap category leads to higher multiples (case study Tech Mahindra). We expect MTCL to break into the large-cap league and hence believe current valuations are justified.

Right portfolio mix – of emerging and traditional business

MTCL has the right mix of emerging businesses – digital (35%) and ER&D (20%). Specialization in chosen verticals and deep account mining has led the growth. Going ahead, MTCL has increased its focus on emerging businesses – it is the first mid-cap company to introduce a new business model for tapping its clients' digital spends.

Strong growth to over FY15-18

MTCL delivered a strong 13% CAGR over FY12-15 as its 'back-to-basics' strategy yielded results. Over the last two years, eight of MTCL's top-40 accounts have grown above company average, driving superior growth. Growth has come from focus on client mining through account managers for top-forty accounts. We expect MTCL to continue to improve its wallet-share in top accounts and deliver revenue CAGR of 17% over FY15-18E — highest in our coverage universe.

Focused acquisitions

MTCL management says focused acquisition is one of the pillars of its growth strategy. It has setup 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 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.

Successful migration into the top bracket of the sector will lead to rerating

MTCL is currently trading at 15.5x our FY17 EPS estimates, which is in line with the large-caps valuations *(infact at premium to HCL Tech and Wipro)* and premium to mid-cap companies. MTCL has all the necessary qualities to break into the large-cap space and hence warrants such valuations based on earnings visibility and superior portfolio mix. We draw our inference from the rerating of Tech Mahindra, which moved into the top bracket after acquiring Satyam – leading to a sharp rerating. We expect the same for MTCL.

Key concerns: Management churn to weaken account mining

In the last few quarters, MTCL saw multiple top-level exits that 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.

Outlook and valuations – good franchise commands premium

We expect revenue CAGR of 17% over FY15-18 — highest in our coverage universe. It appears well set to achieve FY16 organic growth in the 12-14% (NASSCOM guidance) on the back of acceleration in top clients and superior business mix. Acquisition in digital space will lead to industry leading growth. We expect earnings CAGR of 19% over FY15-18, despite continued investments for expanding its digital footprint.

We value the company at Rs 1,625 (Rs 1520 earlier), 16x average of FY17-18 EPS (highest among our mid-cap universe), expecting it to break into the top bracket of the IT sector. We reiterate BUY rating.

BUY (Maintain)

CMP RS 1480

TARGET RS 1625 (+10%)

COMPANY DATA

O/S SHARES (MN) :	84
MARKET CAP (RSBN) :	123
MARKET CAP (USDBN) :	1.8
52 - WK HI/LO (RS) :	1605 / 1154
LIQUIDITY 3M (USDMN) :	5.3
PAR VALUE (RS) :	10

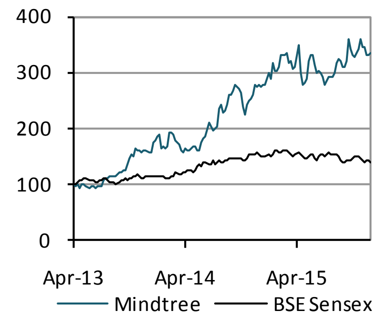
SHARE HOLDING PATTERN, %

	Sep 15	Jun 15	Mar 15
PROMOTERS :	13.8	13.7	13.7
FII / NRI :	41.8	42.2	46.3
FI / MF :	7.3	7.4	7.9
NON PRO :	15.9	15.1	14.1
PUBLIC & OTHERS :	25.8	26.0	26.5

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	-2.8	7.2	24.4
REL TO BSE	-1.6	8.7	31.7

PRICE VS. SENSEX



Source: Phillip Capital India Research

KEY FINANCIALS

Rs mn	FY16E	FY17E	FY18E
Net Sales	45,405	53,023	60,449
EBIDTA	8,490	10,749	12,228
Net Profit	6,270	7,970	9,066
EPS, Rs	74.8	95.1	108.2
PER, x	19.8	15.6	13.7
EV/EBIDTA, x	14.3	10.8	8.9
P/BV, x	5.0	4.0	3.3
ROE, %	25.4	26.0	24.1

Source: PhillipCapital India Research Est.

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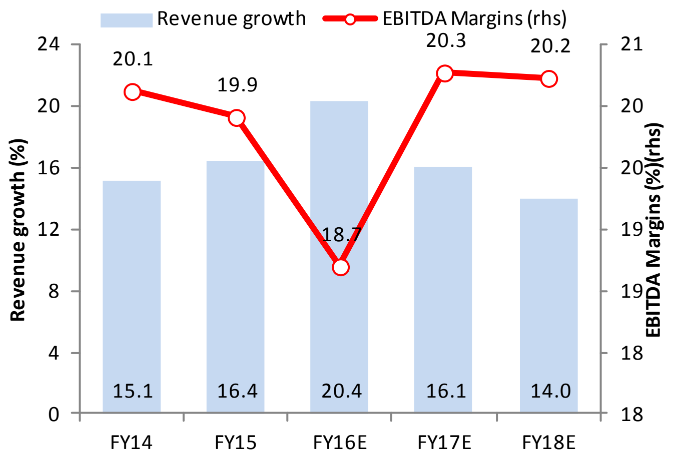
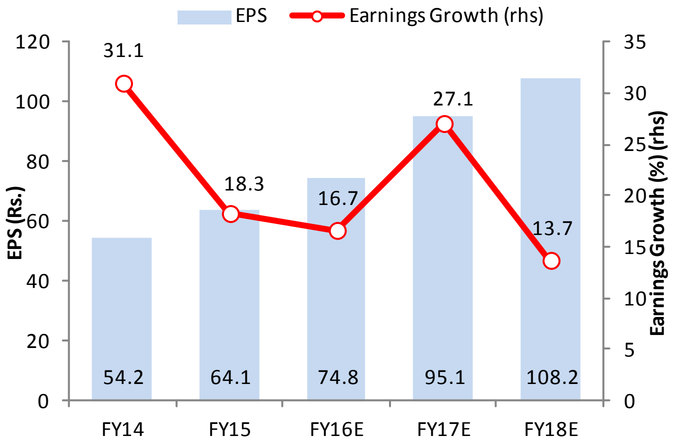
USD revenue growth (%) and EBITDA margins (%)



EPS (Rs) and earnings growth (%)



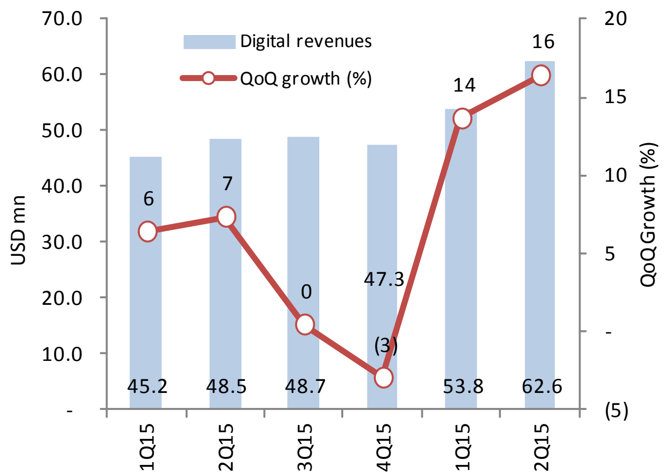
Source: Company, Phillip Capital India Research

MTCL's acquisition history

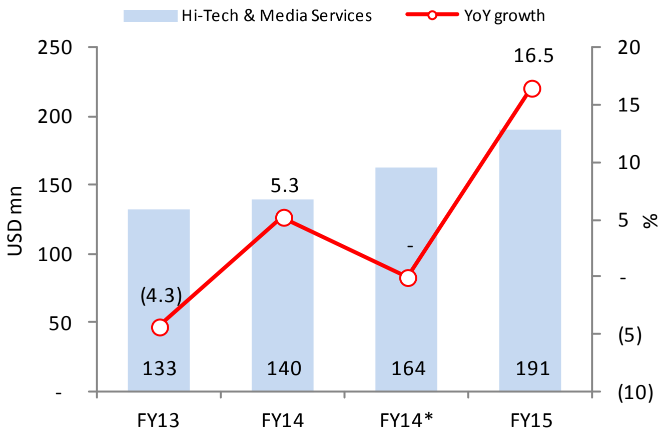
Company	Space	Year	Revenue (US$)	Price(US$ mn)	Employees	Multiple
ASAP Solutions	SAP & ERP					
TES-Purple Vision	Electronics(IC Design).	2007	4.5-5	6.5	150	1.4
Aztecsoft	Product engineering and Testing services company	2008	6.3	40	2200	NA
Kyocera Wireless India Pvt Ltd	Wireless services.	2009	NA	6.2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

Source: Company, Phillip Capital India Research

Digital revenues picking up momentum



Hi Tech revenues



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

Financials

Income Statement

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Net sales	**35,619**	**45,405**	**53,023**	**60,449**
Growth, %	17.5	27.5	16.8	14.0
Total income	35,619	45,405	53,023	60,449
Other Operating expenses	-28,527	-36,915	-42,275	-48,222
EBITDA (Core)	**7,092**	**8,490**	**10,749**	**12,228**
Growth, %	16.3	19.7	26.6	13.8
Margin, %	19.9	18.7	20.3	20.2
Depreciation	-1,018	-1,356	-1,591	-1,813
EBIT	**6,074**	**7,134**	**9,158**	**10,414**
Growth, %	14.8	17.4	28.4	13.7
Margin, %	17.1	15.7	17.3	17.2
Interest paid	0	0	0	0
Other Non-Operating Income	834	925	1,060	1,209
Pre-tax profit	**6,908**	**8,059**	**10,219**	**11,623**
Tax provided	-1,545	-1,789	-2,248	-2,557
Profit after tax	**5,363**	**6,270**	**7,970**	**9,066**
Net Profit	**5,363**	**6,270**	**7,970**	**9,066**
Growth, %	19.0	16.9	27.1	13.7
Net Profit (adjusted)	**5,363**	**6,270**	**7,970**	**9,066**
Unadj. shares (m)	84	84	84	84
Wtd avg shares (m)	84	84	84	84

US$ Revenues

	FY15	FY16E	FY17E	FY18E
US$ Revenue ($ mn)	583.9	702.8	815.7	930.0
Growth, %	16.4	20.4	16.1	14.0
Re / US$ (rate)	61.0	64.6	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Cash & bank	3,763	3,358	8,604	15,018
Debtors	6,963	8,987	10,495	11,965
Loans & advances	1,490	1,594	1,594	1,594
Other current assets	1,621	1,948	2,279	2,598
Total current assets	13,837	15,887	22,972	31,175
Investments	5,351	5,518	5,518	5,518
Gross fixed assets	5,555	8,704	8,738	8,550
Add: Capital WIP	354	354	354	354
Net fixed assets	5,909	9,058	9,092	8,904
Non-current assets	1,003	1,039	1,039	1,039
Total assets	**26,549**	**31,951**	**39,070**	**47,085**
Current liabilities	4,001	4,921	5,719	6,497
Provisions	2,063	2,035	2,336	2,653
Total current liabilities	6,064	6,956	8,055	9,149
Non-current liabilities	357	357	357	357
Total liabilities	6,421	7,313	8,412	9,506
Paid-up capital	837	837	837	837
Reserves & surplus	19,291	23,801	29,821	36,741
Shareholders' equity	20,128	24,638	30,658	37,578
Total equity & liabilities	**26,549**	**31,951**	**39,070**	**47,085**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Pre-tax profit	6,908	8,059	10,219	11,623
Depreciation	1,018	1,356	1,591	1,813
Chg in working capital	411	-1,571	-1,041	-1,011
Total tax paid	-1,103	-1,817	-1,947	-2,241
Cash flow from operating activities	**7,234**	**6,026**	**8,822**	**10,185**
Capital expenditure	-2,995	-4,505	-1,625	-1,625
Chg in investments	-16	-167	0	0
Cash flow from investing activities	**-3,011**	**-4,672**	**-1,625**	**-1,625**
Free cash flow	4,223	1,354	7,197	8,560
Equity raised/(repaid)	424	-4	0	0
Debt raised/(repaid)	-4	0	0	0
Dividend (incl. tax)	-1,657	-1,755	-1,951	-2,146
Cash flow from financing activities	**-1,644**	**-1,759**	**-1,951**	**-2,146**
Net chg in cash	2,579	-405	5,246	6,414

Valuation Ratios

	FY15	FY16E	FY17E	FY18E
Per Share data				
EPS (INR)	64.1	74.8	95.1	108.2
Growth, %	18.3	16.7	27.1	13.7
Book NAV/share (INR)	240.7	294.0	365.8	448.4
FDEPS (INR)	63.9	74.6	94.8	107.9
CEPS (INR)	76.3	91.0	114.1	129.8
CFPS (INR)	76.1	61.3	92.6	107.1
DPS (INR)	17.1	18.1	20.1	22.1
Return ratios				
Return on assets (%)	22.6	21.4	22.4	21.0
Return on equity (%)	26.6	25.4	26.0	24.1
Return on capital employed (%)	28.9	27.6	28.5	26.3
Turnover ratios				
Asset turnover (x)	3.3	3.2	3.1	3.4
Sales/Total assets (x)	1.5	1.6	1.5	1.4
Sales/Net FA (x)	7.2	6.1	5.8	6.7
Working capital/Sales (x)	0.1	0.1	0.1	0.1
Receivable days	71.4	72.2	72.2	72.2
Payable days	6.9	4.0	4.1	4.1
Working capital days	41.1	44.8	43.5	42.3
Liquidity ratios				
Current ratio (x)	2.3	2.3	2.9	3.4
Quick ratio (x)	2.3	2.3	2.9	3.4
Dividend cover (x)	3.8	4.1	4.7	4.9
Total debt/Equity (%)	0.1	0.1	0.1	0.1
Net debt/Equity (%)	(18.6)	(13.5)	(28.0)	(39.9)
Valuation				
PER (x)	23.1	19.8	15.6	13.7
PEG (x) - y-o-y growth	1.3	1.2	0.6	1.0
Price/Book (x)	6.1	5.0	4.0	3.3
Yield (%)	1.2	1.2	1.4	1.5
EV/Net sales (x)	3.4	2.7	2.2	1.8
EV/EBITDA (x)	17.0	14.3	10.8	8.9

NIIT Tech (NITEC IN)

Changing DNA; rerating imminent

INDIA | IT SERVICES | Company Update

22 December 2015

DNA significantly changed in the last two years

In FY14, NIIT Tech hired Sudhir Chaturvedi as COO of the company from Infosys. He laid out a strategy of (1) cross-selling IMS, (2) expanding BFSI business in the US, and (3) securing leader position in transport vertical. The company also laid out a strategy to reduce low-margin government business. Its strategy execution in the next two years resulted in IMS growth of 55%, contribution from US geography increasing to 44% from 37%, and contribution from government business reducing to 5% from 15%. However, transport growth lagged because of a client-specific issue. Partial success in the strategy has resulted in change in business mix and changed the DNA of the organization. This changed DNA and clear focus will lead to acceleration in revenue growth, over the next three years.

Strong growth expected over FY15-17

NITEC delivered a weak 5% CAGR over FY13-15 as the management was rationalising its portfolio to exit its low-margin government business and focus on the high-margin onsite business. Rationalisation 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 largely consists of high-margin onsite revenue. We believe the current order book will lead to revenue CAGR of 13% over FY15-18, providing levers for margin expansion, at the same time.

Adding digital to its focus list

After the partial success of its previous strategy, NITEC has set out to increase its digital presence with clients in FY16. The company hired Graham Clark in August 2015 to head the digital business (from August 2015) and acquired Incessant Technologies (global BPM specialist). Currently 14% of its business is from digital. We believe with large accounts in TTL and customer experience being one of the biggest spending areas in digital, NITEC is well placed to gain share in the digital wallet of its clients.

Order book characteristics changes

The Company secured fresh orders worth U$$ 425mn during FY15, with 67% of it coming from the US and Europe. Despite that, the executable order book has remained stagnant at US$ 295mn in FY15 (US$ 290mn in FY14). While this has been a cause of concern, what largely needs to be understood is the changing nature of the order book. Digital business contributed 14% of revenue in FY15, and most digital projects being shorter in duration, lead to shorter execution timeframe for the orderbook. We expect book to bill ratio to remain in the range of 1.3x to 1.4x on account of this changed characteristic of order book.

Outlook and valuations – turnaround story playing out as expected

NITEC's strategy for FY16 – to increase its digital presence with its clients and increase presence in BFSI in the US – is playing out along expected lines. This, in conjunction with the success of the earlier strategy, should enable the company to report double digit growth over the next three years. We do not expect the lower fresh orderbook to be a major concern in the turnaround story.

We maintain our FY16-17 estimates and introduce FY18 estimates, rolling forward our valuation to average of FY17-18 P/E. We rate NITEC our top pick in the IT-midcap space, with relatively inexpensive valuations (12x FY17E) and strong growth profile. We maintain our multiple of 12x – second only to Mindtree in the midcap coverage. Our price target of Rs 650 (Rs 600 earlier) offers 11% upside from current levels. We Maintain BUY.

BUY (Maintain)

CMP RS 586

TARGET RS 650 (+11%)

COMPANY DATA

O/S SHARES (MN) :	61
MARKET CAP (RSBN) :	37
MARKET CAP (USDBN) :	0.5
52 - WK HI/LO (RS) :	631 / 326
LIQUIDITY 3M (USDMN) :	5.9
PAR VALUE (RS) :	10

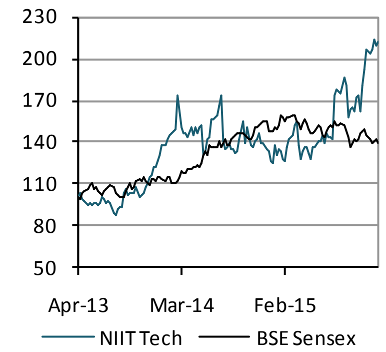
SHARE HOLDING PATTERN, %

	Sep 15	Jun 15	Mar 15
PROMOTERS :	30.8	30.9	30.9
FII / NRI :	33.1	34.9	34.2
FI / MF :	21.2	18.4	18.4
NON PRO :	4.7	5.6	5.7
PUBLIC & OTHERS :	11.3	11.4	12.0

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	5.9	36.7	69.6
REL TO BSE	7.0	38.2	76.9

PRICE VS. SENSEX



Source: Phillip Capital India Research

KEY FINANCIALS

Rs mn	FY16E	FY17E	FY18E
Net Sales	27,375	30,367	34,069
EBIDTA	4,678	5,028	5,713
Net Profit	2,766	3,018	3,523
EPS, Rs	45.6	49.8	58.1
PER, x	12.9	11.8	10.1
EV/EBIDTA, x	7.4	6.4	5.1
P/BV, x	1.3	1.1	0.9
ROE, %	17.6	16.8	17.0

Source: PhillipCapital India Research Est.

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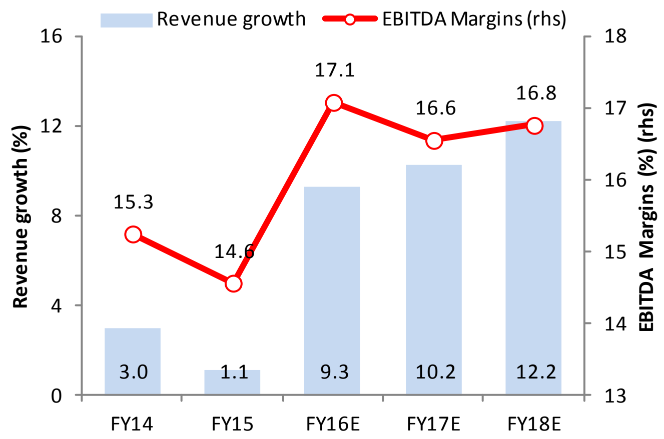
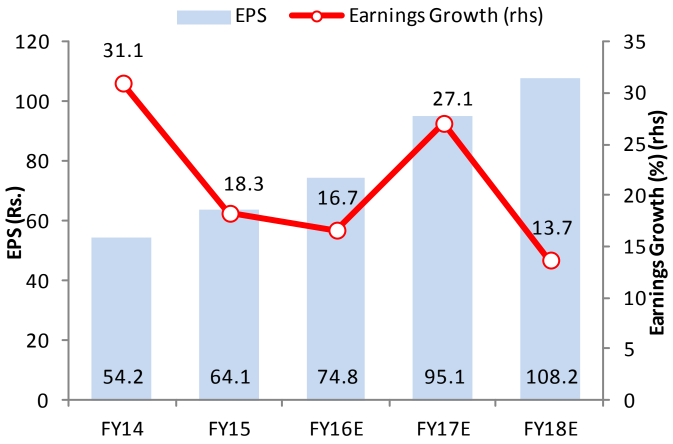
USD revenue growth (%) and EBITDA margins (%)

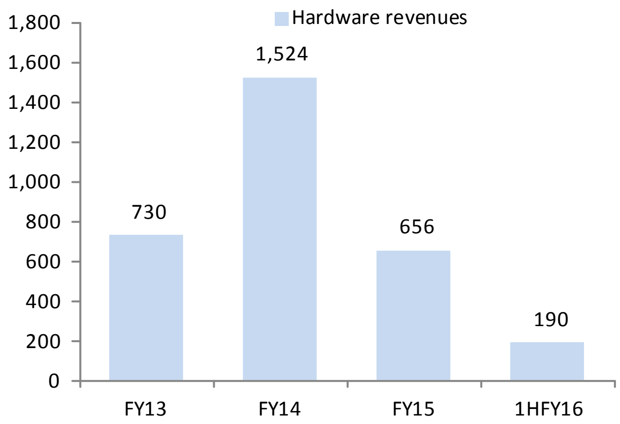


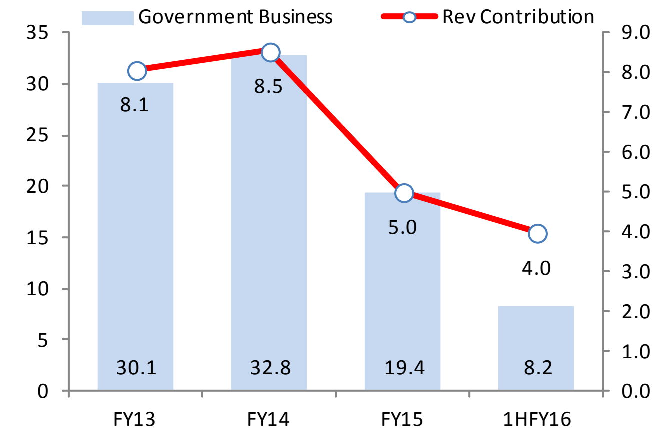
EPS (Rs) and earnings growth (%)



Source: Company, Phillip Capital India Research

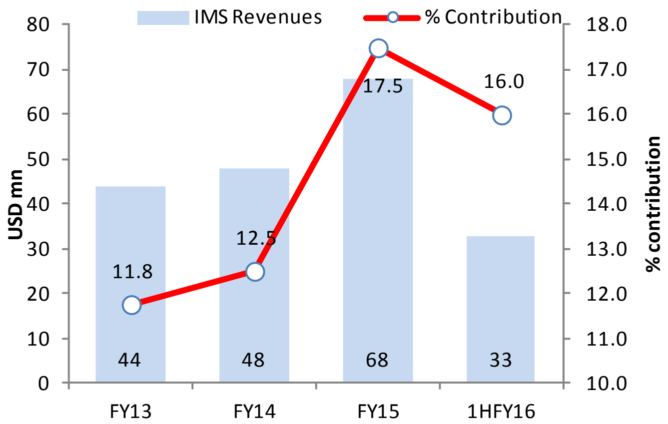
Declining revenues from hardware and government business – as per NITEC's strategy

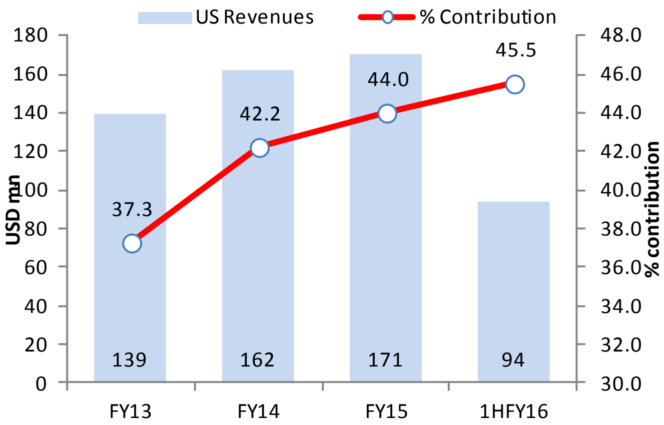




Source: Company, Phillip Capital India Research

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





Source: Company, Phillip Capital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Net sales	**23,724**	**27,375**	**30,367**	**34,069**
Growth, %	2.9	15.4	10.9	12.2
Employee expenses	-15,656	-17,318	-19,335	-21,753
Other Operating expenses	-4,612	-5,379	-6,004	-6,603
EBITDA (Core)	**3,456**	**4,678**	**5,028**	**5,713**
Growth, %	-1.7	35.4	7.5	13.6
Margin, %	14.6	17.1	16.6	16.8
Depreciation	-916	-1,110	-1,077	-1,121
EBIT	**2,540**	**3,568**	**3,951**	**4,591**
Growth, %	(12.3)	40.5	10.7	16.2
Margin, %	10.7	13.0	13.0	13.5
Interest paid	0	0	0	0
Other Non-Operating Income	-781	341	311	383
Pre-tax profit	**1,759**	**3,908**	**4,262**	**4,975**
Tax provided	-541	-965	-1,151	-1,343
Profit after tax	**1,218**	**2,943**	**3,111**	**3,632**
Others (Minorities, Associates)	-79	-177	-93	-109
Net Profit	**1,139**	**2,766**	**3,018**	**3,523**
Growth, %	(50.6)	142.9	9.1	16.7
Net Profit (adjusted)	**1,139**	**2,766**	**3,018**	**3,523**
Wtd avg shares (m)	61	61	61	61

US$ Revenues

	FY15	FY16E	FY17E	FY18E
US$ Revenue ($ mn)	**387.9**	**423.8**	**467.2**	**524.1**
Growth, %	1.1	9.3	10.2	12.2
Re / US$ (rate)	61.2	64.6	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Cash & bank	3,185	1,087	3,607	6,764
Marketable securities at cost	0	0	0	0
Debtors	6,060	6,825	7,488	8,401
Inventory	52	52	52	52
Other current assets	1,717	2,040	2,214	2,439
Total current assets	12,410	11,662	15,255	19,831
Investments	551	2,301	1,551	801
Net fixed assets	6,421	7,467	7,589	7,268
Non-current assets	0	0	0	0
Total assets	**19,768**	**21,797**	**24,763**	**28,267**
Total current liabilities	5,921	5,348	5,970	6,681
Non-current liabilities	84	79	90	103
Total liabilities	6,005	5,427	6,060	6,784
Paid-up capital	610	611	611	611
Reserves & surplus	12,964	15,142	17,380	20,052
Minorities	189	618	712	820
Shareholders' equity	13,763	16,371	18,702	21,483
Total equity & liabilities	**19,768**	**21,797**	**24,763**	**28,267**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Pre-tax profit	1,759	3,908	4,262	4,975
Depreciation	916	1,110	1,077	1,121
Chg in working capital	1,407	-1,923	-450	-709
Total tax paid	-704	-947	-1,151	-1,343
Other operating activities	0	0	0	0
Cash flow from operating activities	**3,378**	**2,148**	**3,739**	**4,044**
Capital expenditure	-1,517	-2,156	-1,200	-800
Chg in investments	0	-1,750	750	750
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-1,517**	**-3,906**	**-450**	**-50**
Free cash flow	1,861	-1,758	3,289	3,994
Equity raised/(repaid)	3	1	0	0
Debt raised/(repaid)	-5	-5	11	13
Dividend (incl. tax)	-674	-745	-780	-780
Other financing activities	-133	156	0	-71
Cash flow from financing activities	**-888**	**-341**	**-769**	**-838**
Net chg in cash	973	-2,098	2,520	3,157

Valuation Ratios

	FY15	FY16E	FY17E	FY18E
Per Share data				
EPS (INR)	18.8	45.6	49.8	58.1
Growth, %	(50.8)	142.7	9.1	16.7
Book NAV/share (INR)	224.0	259.9	296.8	340.9
CFPS (INR)	68.6	29.8	56.6	60.4
DPS (INR)	9.5	10.5	11.0	11.0
Return ratios				
Return on assets (%)	6.4	14.2	13.4	13.7
Return on equity (%)	8.4	17.6	16.8	17.0
Return on capital employed (%)	8.1	17.8	16.3	16.7
Turnover ratios				
Asset turnover (x)	2.1	2.2	2.1	2.3
Sales/Total assets (x)	1.3	1.3	1.3	1.3
Sales/Net FA (x)	3.9	3.9	4.0	4.6
Working capital/Sales (x)	0.2	0.2	0.2	0.2
Receivable days	93.2	91.0	90.0	90.0
Liquidity ratios				
Current ratio (x)	2.8	2.9	3.4	4.0
Quick ratio (x)	2.8	2.9	3.4	3.9
Dividend cover (x)	2.0	4.3	4.5	5.3
Total debt/Equity (%)	0.6	0.5	0.5	0.5
Net debt/Equity (%)	(22.8)	(6.4)	(19.5)	(32.2)
Valuation				
PER (x)	31.3	12.9	11.8	10.1
PEG (x) - y-o-y growth	(0.6)	0.1	1.3	0.6
Price/Book (x)	2.6	2.3	2.0	1.7
Yield (%)	1.6	1.8	1.9	1.9
EV/Net sales (x)	1.4	1.3	1.1	0.9
EV/EBITDA (x)	9.4	7.4	6.4	5.1
EV/EBIT (x)	12.8	9.7	8.1	6.3

INSTITUTIONAL EQUITY RESEARCH

PhillipCapital

KPIT (KPIT IN)

Wrong place, wrong time!

INDIA | IT SERVICES | Company Update

22 December 2015

Growth concerns

KPIT has delivered tepid growth over the last two years. The company has missed its guidance for last two consecutive years. Growth tepidness has been primarily due to (1) leakages in its top-10 clients, (2) delay in its SAP business revival due to slower project ramp-up and (3) cost overruns. We expect the growth to remain tepid as revival in SAP, wallet share gains in its largest client (Cummins), and growth in its automotive business are long drawn out processes. On our estimates, KPIT should see revenue CAGR of 7% over FY15-18 and earnings CAGR of 11%.

SAP business – wrong place, wrong time

KPIT's SAP 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 significant presence in SAP domain, but with capabilities in the older version, which was slowly becoming obsolete. This lack of foresight from the management led to KPIT not being able to cater to the demand in the SAP business – leading to 11% 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 double whammy for the earnings. KPIT spend USD 107mn to upgrade the employee skillset in SAP HANA. While the vertical has shown signs of revival in last two quarters, we believe the damage has already been done, with the company missing out on a significant growth opportunity. We fear revival in SAP business, hereafter, will be slow and gradual. We see KPIT as the first causality of a shift in technology to cloud from on-premise.

Cash flow constrains inorganic growth

KPIT reported strong growth of 31% over FY10-14, because of acquisitions. The company spent US$ 107mn over the period to acquire 5 companies. The inorganic strategy helped meet guidance and achieve scale. But the same led to its equity being diluted to 199 mn shares in FY15 from 157 mn in FY10. Over the period, the debt also increased to Rs 1108mn from Rs 4457mn. It remains the only company in the IT Services coverage to possess a leverage balance sheet and report negative FCF. Over the last five years, the company has reported negative FCF of Rs 848mn. We believe lack of inorganic drivers (due to cash flow constraints) and failure in integrating earlier acquisitions, will lead to the growth trajectory flattening for the company.

Business requires significant rebuilding

KPIT's growth has remained tepid in the past two years (9% CAGR) and we expect muted 10% CAGR over FY16-18 because of leakages in top-10 clients, delay in SAP business revival, and losing wallet share in top client Cummins. Change in business environment and the challenges that KPIT faces in SAP/ERP unit will make the turnaround process much more long drawn out than anticipated.

KPIT's stock has run up significantly in the last few months (+57%, 3m) on hopes of turnaround in the SAP business. While we do believe that the worst is behind for the company, and growth/margins should improve from current levels, we believe the recent move is unwarranted. At current levels, the stock is trading at 12x FY17 P/E – expensive in our opinion, considering the inferior returns (ROE of 15%) and delay in SAP business revival.

We maintain our FY16-17 estimate and introduce FY18 estimates, rolling forward our valuation to average of FY17-18 P/E. We upgrade multiple to 9x (from 8x earlier) – still lowest in our midcap coverage universe, based on weak cash-conversion cycle and profitability. Our price target of Rs 140 (Rs 120 earlier) offers 18% downside from current levels. We downgrade to SELL.

Downgrade to SELL

CMP RS 170

TARGET RS 140 (-18%)

COMPANY DATA

O/S SHARES (MN) :	197
MARKET CAP (RSBN) :	34
MARKET CAP (USDBN) :	0.5
52 - WK HI/LO (RS) :	233 / 85
LIQUIDITY 3M (USDMN) :	2.3
PAR VALUE (RS) :	2

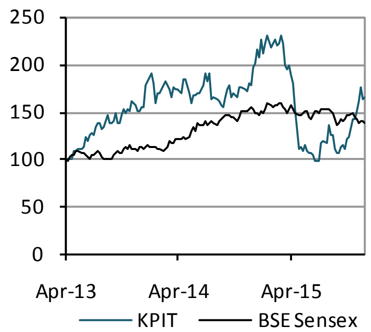
SHARE HOLDING PATTERN, %

	Sep 15	Jun 15	Mar 15
PROMOTERS :	22.3	21.7	21.7
FII / NRI :	50.2	47.6	47.9
FI / MF :	5.6	7.7	11.2
NON PRO :	23.8	22.0	20.0
PUBLIC & OTHERS :	18.1	19.4	15.9

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	12.7	72.7	-13.2
REL TO BSE	13.8	74.2	-5.9

PRICE VS. SENSEX



Source: Phillip Capital India Research

KEY FINANCIALS

Rs mn	FY16E	FY17E	FY18E
Net Sales	32,150	35,491	39,024
EBIDTA	3,914	4,432	4,833
Net Profit	2,584	2,879	3,291
EPS, Rs	12.9	14.4	16.5
PER, x	12.4	11.1	9.7
EV/EBIDTA, x	8.5	7.0	6.0
P/BV, x	2.1	1.8	1.5
ROE, %	16.7	15.9	15.6

Source: PhillipCapital India Research Est.

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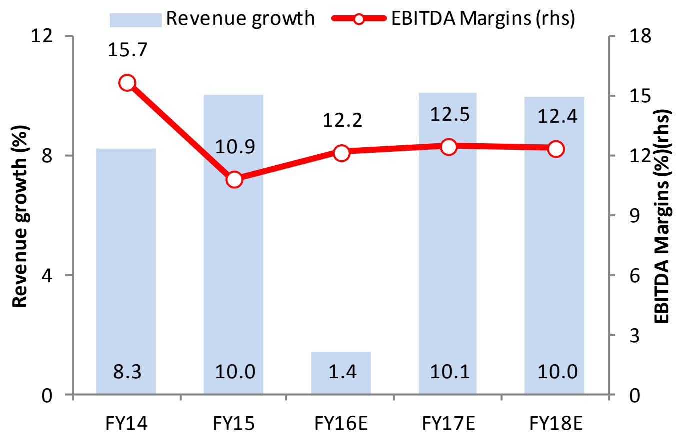
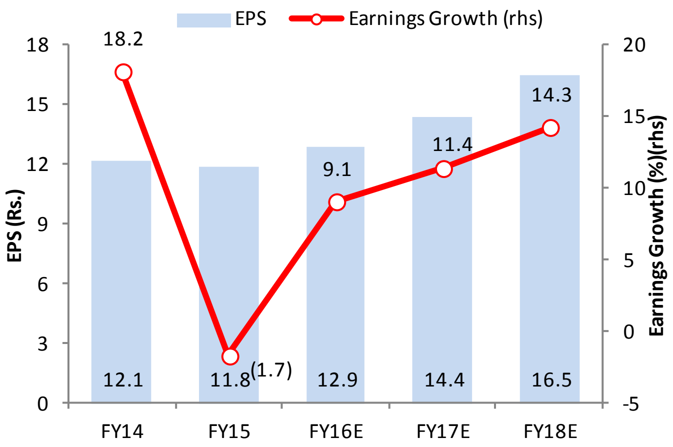
USD revenue growth (%) and EBITDA margins (%)

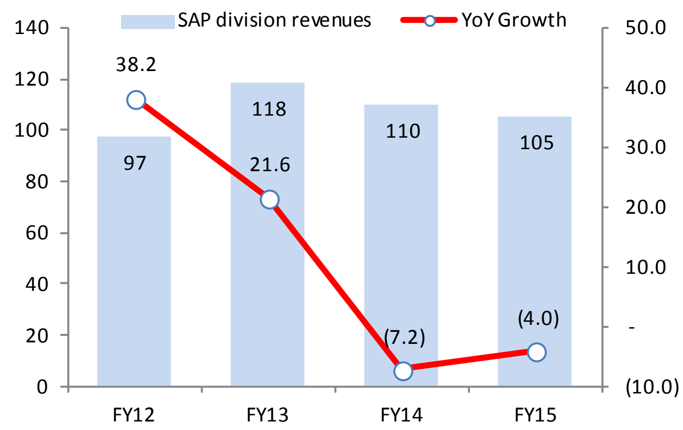


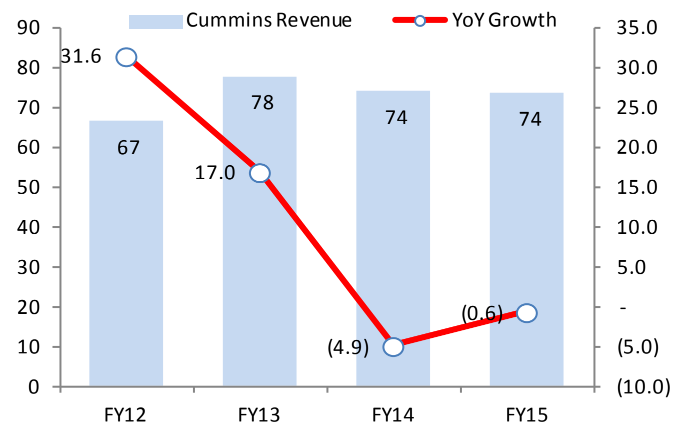
EPS (Rs) and earnings growth (%)



Source: Company, Phillip Capital India Research

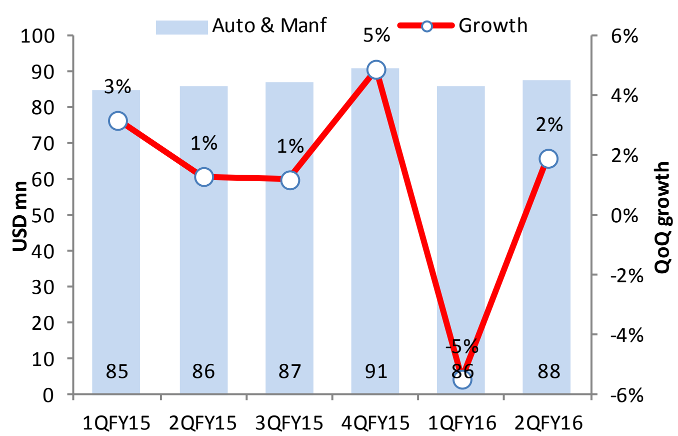
Declining revenue trends from SAP business and top client (Cummins)

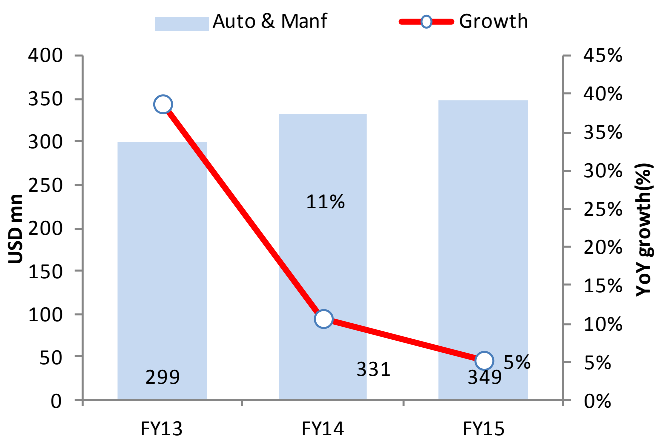




Source: Company, Phillip Capital India Research

Growth in Auto and Manufacturing has also been tepid





Source: Company, Phillip Capital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Net sales	**29,899**	**32,150**	**35,491**	**39,024**
Growth, %	11.0	7.5	10.4	10.0
Employee expenses	-22,442	-23,755	-26,398	-29,060
Other Operating expenses	-4,213	-4,481	-4,660	-5,130
EBITDA (Core)	**3,244**	**3,914**	**4,432**	**4,833**
Growth, %	(23.4)	20.6	13.2	9.1
Margin, %	10.9	12.2	12.5	12.4
Depreciation	-851	-653	-649	-636
EBIT	**2,393**	**3,261**	**3,783**	**4,197**
Growth, %	(35.2)	36.3	16.0	10.9
Margin, %	8.0	10.1	10.7	10.8
Interest paid	-276	-169	-147	-122
Other Non-Operating Income	352	360	281	433
Pre-tax profit	**2,469**	**3,451**	**3,918**	**4,508**
Tax provided	-115	-867	-1,038	-1,217
Profit after tax	**2,354**	**2,584**	**2,879**	**3,291**
Others (Minorities, Associates)	0	0	0	0
Net Profit	**2,354**	**2,584**	**2,879**	**3,291**
Growth, %	(1.6)	9.8	11.4	14.3
Net Profit (adjusted)	**2,354**	**2,584**	**2,879**	**3,291**
Wtd avg shares (m)	187	188	188	188

US$ Revenues

	FY15	FY16E	FY17E	FY18E
US$ Revenue ($ mn)	**489**	**496**	**546**	**600**
Growth, %	10.0	1.4	10.1	10.0
Re / US$ (rate)	61.1	64.8	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Cash & bank	3,638	5,181	6,477	7,948
Marketable securities at cost	0	0	0	0
Debtors	6,979	7,574	8,319	9,211
Inventory	0	0	0	0
Other current assets	1,942	1,916	2,105	2,330
Total current assets	12,559	14,670	16,900	19,489
Investments	590	1,090	1,590	2,090
Net fixed assets	7,416	7,263	7,114	6,979
Non-current assets	2,136	2,136	2,136	2,136
Total assets	**22,701**	**25,159**	**27,741**	**30,694**
Total current liabilities	5,282	5,417	5,969	6,519
Non-current liabilities	4,457	4,307	3,707	3,107
Total liabilities	9,739	9,724	9,676	9,626
Paid-up capital	386	386	386	386
Reserves & surplus	12,576	15,050	17,679	20,681
Minorities	0	0	0	0
Shareholders' equity	12,962	15,436	18,064	21,067
Total equity & liabilities	**22,701**	**25,159**	**27,741**	**30,693**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Pre-tax profit	2,469	3,451	3,918	4,508
Depreciation	851	653	649	636
Chg in working capital	-628	-434	-381	-568
Total tax paid	75	-867	-1,038	-1,217
Other operating activities	0	0	0	0
Cash flow from operating activities	**2,768**	**2,803**	**3,147**	**3,358**
Capital expenditure	-113	-500	-500	-500
Chg in investments	1,151	-500	-500	-500
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**1,038**	**-1,000**	**-1,000**	**-1,000**
Free cash flow	3,806	1,803	2,147	2,358
Equity raised/(repaid)	-7	-8	0	0
Debt raised/(repaid)	67	-150	-600	-600
Dividend (incl. tax)	-206	-225	-225	-225
Other financing activities	-1,930	123	-26	-63
Cash flow from financing activities	**-2,076**	**-260**	**-851**	**-888**
Net chg in cash	1,730	1,543	1,296	1,470

Valuation Ratios

	FY15	FY16E	FY17E	FY18E
Per Share data				
EPS (INR)	11.8	12.9	14.4	16.5
Growth, %	(1.7)	9.1	11.4	14.3
Book NAV/share (INR)	69.3	82.0	96.0	111.9
CFPS (INR)	18.0	13.0	15.2	15.5
DPS (INR)	0.9	1.0	1.0	1.0
Return ratios				
Return on assets (%)	11.5	11.3	11.2	11.5
Return on equity (%)	18.2	16.7	15.9	15.6
Return on capital employed (%)	14.6	14.5	14.3	14.7
Turnover ratios				
Asset turnover (x)	2.5	2.8	3.0	3.2
Sales/Total assets (x)	1.4	1.3	1.3	1.3
Sales/Net FA (x)	3.8	4.4	4.9	5.5
Working capital/Sales (x)	0.1	0.1	0.1	0.1
Receivable days	85.2	86.0	85.6	86.2
Liquidity ratios				
Current ratio (x)	2.4	2.7	2.8	3.0
Quick ratio (x)	2.4	2.7	2.8	3.0
Interest cover (x)	8.7	19.2	25.7	34.4
Dividend cover (x)	13.3	13.3	14.9	-
Total debt/Equity (%)	34.4	27.9	20.5	14.7
Net debt/Equity (%)	6.3	(5.7)	(15.3)	(23.0)
Valuation				
PER (x)	13.5	12.4	11.1	9.7
PEG (x) - y-o-y growth	(8.0)	1.4	1.0	0.7
Price/Book (x)	2.5	2.1	1.8	1.5
Yield (%)	0.6	0.6	0.6	-
EV/Net sales (x)	1.2	1.0	0.9	0.7
EV/EBITDA (x)	10.7	8.5	7.0	6.0
EV/EBIT (x)	14.5	10.2	8.3	6.9

Persistent (PSYS IN)

Its a long road to enterprise business ...

INDIA | IT SERVICES | Company Update

22 December 2015

Long road to enter the enterprise segment

Persistent Systems (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. Being a pioneer in the space of digital technology (much ahead of the larger IT Services companies) it is targeting enterprise digital transformational (EDT) deals – where it will provide customized digital solutions to enterprise customers – as opposed to product companies, which it was catering to, till date.

While this might be the correct strategy to embark upon a new growth wave, we believe it will be an arduous task – which will require significant investment. Most enterprises today are either choosing an existing vendor, or large global consultant – as they 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. Also, the benefits of this strategy will also be highly back-ended, while it will require upfront investments. The company does not, yet, has an EDT account greater than $1mn.

Also, we note that the enterprise customers, whom PSYS is targeting, are also the end customers of its existing OSPD clients. While PSYS management has maintained it will follow a cautious approach to target relatively small end customers of its OSPD clients, we fear it losing some of its OSPD clients, over the next few years.

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

PSYS's IP led revenues have declined by CQGR of 2% over the last six quarters – infact the company hasn't been able to breach the $15mn quarterly run-rate, that it achieved in Q1FY15. While the management has guided to IP revenues reaching to 20% of total revenues by 4QFY16 (from the current 16.2%) on the back of Aepona acquisition, the organic growth engine in the IP business clearly seems to be decelerating. The company would need to invest more, to achieve double digit growth in this business.

Muted growth with depleting margins

Over the last six quarters, PSYS has reported US$ revenue CQGR of only 2.2%. Its margins have decline by 830bps (from 27% in 4QFY14 to 18.7% n 2QFY16) despite currency tailwinds. As a result, its earnings have reported CQGR of only 1.1% over the same period. We do not see these numbers improving significantly from here. We expect the back-ended rewards of its EDT strategy and decelerating IP business to lead to single-digit growth in revenues. At the same time, margins are expected to remain under pressure, as the EDT strategy would require significant investments.

Expensive valuations; downgrade to SELL

At current levels, the stock is trading at 16x our FY17 earnings – a significant premium to its historical average and the IT-midcap average. Infact, the stock is also trading at premium to all large cap companies (excl TCS) – which have much more diversified profile, higher margins and superior return ratios. With growth expectations set significantly lower, due to recent muted performance, we see no reason for the stock to trade at such rich valuations. We also note that consensus FY17 estimates allude to 17% revenue growth in FY17 – despite only 8% growth expectations in FY16. We expect significant cut in FY17 consensus estimates leading to further pressure on the stock.

We have downgraded our FY17 estimates (-3%) based on lower topline growth than earlier anticipated. We introduce FY18 estimates and roll forward our valuation to average of FY17-18 P/E. We downgrade our multiple to 12x (from 15x earlier). Our price target of Rs 530 (Rs 640 earlier) offers 21% downside from current levels. We downgrade to SELL.

Downgrade to SELL

CMP RS 667

TARGET RS 530 (-21%)

COMPANY DATA

O/S SHARES (MN) :	80
MARKET CAP (RSBN) :	53
MARKET CAP (USDBN) :	0.8
52 - WK HI/LO (RS) :	957 / 85
LIQUIDITY 3M (USDMN) :	0.8
PAR VALUE (RS) :	10

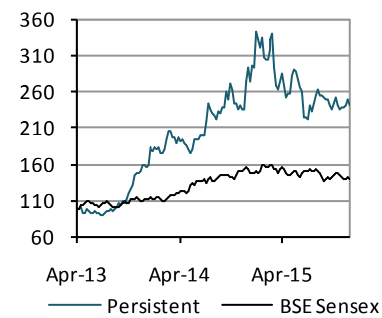
SHARE HOLDING PATTERN, %

	Sep 15	Jun 15	Mar 15
PROMOTERS :	38.5	38.5	38.6
FII / NRI :	29.8	30.8	34.2
FI / MF :	11.3	10.5	9.3
NON PRO :	22.0	19.1	20.3
PUBLIC & OTHERS :	11.1	11.0	8.9

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	1.2	-2.5	-11.6
REL TO BSE	2.4	-1.0	-4.3

PRICE VS. SENSEX



Source: Phillip Capital India Research

KEY FINANCIALS

Rs mn	FY16E	FY17E	FY18E
Net Sales	21,638	23,880	26,058
EBIDTA	4,175	4,549	5,011
Net Profit	2,939	3,326	3,712
EPS, Rs	36.7	41.6	46.4
PER, x	18.2	16.0	14.4
EV/EBIDTA, x	12.4	11.3	10.0
P/BV, x	3.3	2.8	2.5
ROE, %	18.1	17.7	17.1

Source: PhillipCapital India Research Est.

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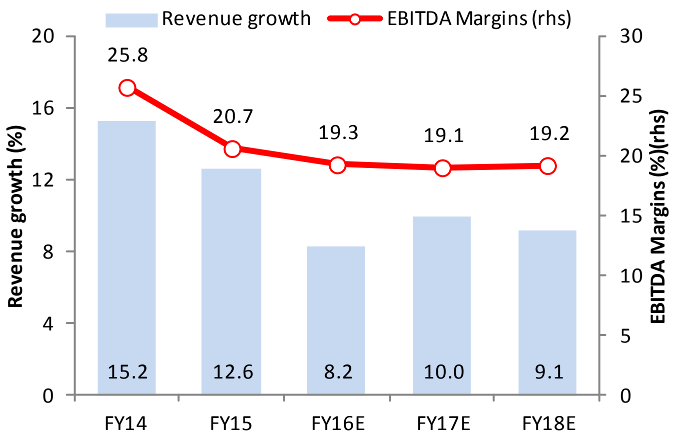
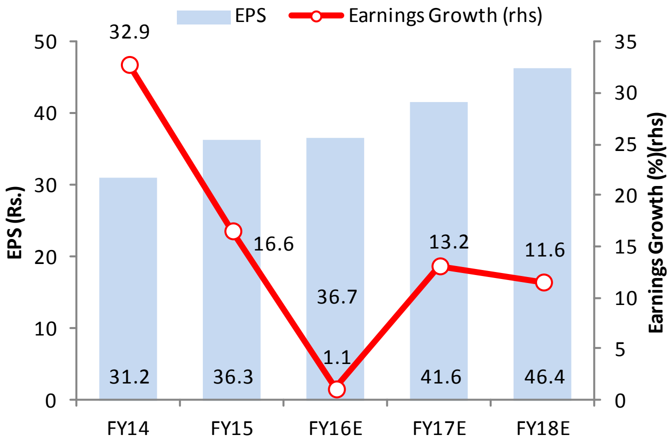
USD revenue growth (%) and EBITDA margins (%)

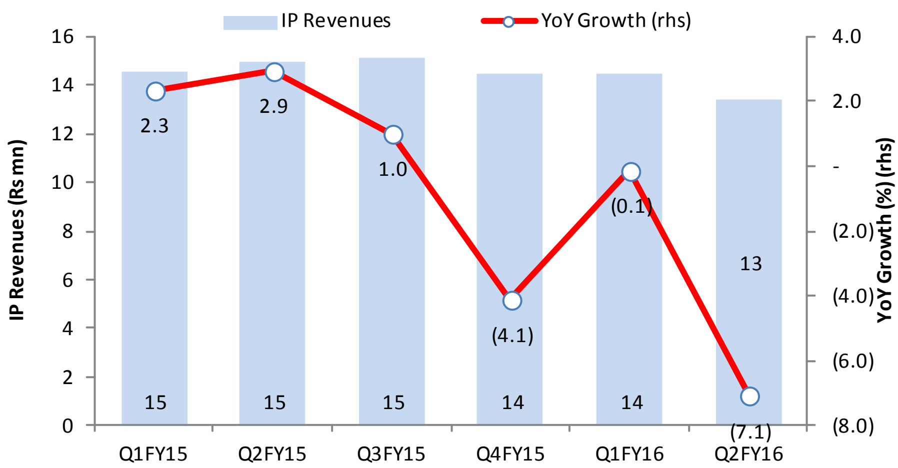


EPS (Rs) and earnings growth (%)



Source: Company, Phillip Capital India Research

IP led revenues have remained largely flat



Source: Company, Phillip Capital India Research

Financials

Income Statement

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Net sales	**18,913**	**21,638**	**23,880**	**26,058**
Growth, %	13.3	14.4	10.4	9.1
Employee expenses	-11,316	-13,156	-14,650	-16,046
Other Operating expenses	-3,690	-4,307	-4,681	-5,001
EBITDA (Core)	**3,906**	**4,175**	**4,549**	**5,011**
Growth, %	(9.2)	6.9	9.0	10.2
Margin, %	20.7	19.3	19.1	19.2
Depreciation	-939	-935	-1,037	-1,129
EBIT	**2,967**	**3,240**	**3,512**	**3,882**
Growth, %	(9.4)	9.2	8.4	10.5
Margin, %	15.7	15.0	14.7	14.9
Interest paid	0	0	0	0
Other Non-Operating Income	463	510	756	1,078
Pre-tax profit	**3,900**	**4,040**	**4,588**	**5,120**
Tax provided	-993	-1,101	-1,262	-1,408
Profit after tax	**2,907**	**2,939**	**3,326**	**3,712**
Others (Minorities, Associates)	0	0	0	0
Net Profit	**2,907**	**2,939**	**3,326**	**3,712**
Growth, %	16.6	1.1	13.2	11.6
Net Profit (adjusted)	**2,907**	**2,939**	**3,326**	**3,712**
Wtd avg shares (m)	80	80	80	80

US$ Revenues

	FY15	FY16E	FY17E	FY18E
US$ Revenue ($ mn)	**309**	**334**	**367**	**401**
Growth, %	12.6	8.2	10.0	9.1
Re / US$ (rate)	61.3	64.8	65.0	65.0

Balance Sheet

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Cash & bank	1,416	1,455	2,172	3,414
Marketable securities at cost	0	0	0	0
Debtors	3,586	4,172	4,511	4,977
Inventory	0	0	0	0
Other current assets	1,035	1,035	1,035	1,035
Total current assets	6,568	7,472	8,661	10,392
Investments	6,749	7,749	8,749	9,749
Net fixed assets	4,093	4,619	5,082	5,453
Non-current assets	24	24	24	24
Total assets	**17,749**	**20,305**	**22,958**	**26,059**
Total current liabilities	3,693	4,035	4,145	4,408
Non-current liabilities	0	0	0	0
Total liabilities	3,693	4,035	4,145	4,408
Paid-up capital	800	800	800	800
Reserves & surplus	13,255	15,470	18,013	20,851
Minorities	0	0	0	0
Shareholders' equity	14,055	16,270	18,813	21,651
Total equity & liabilities	**17,749**	**20,305**	**22,958**	**26,059**

Source: Company, PhillipCapital India Research Estimates

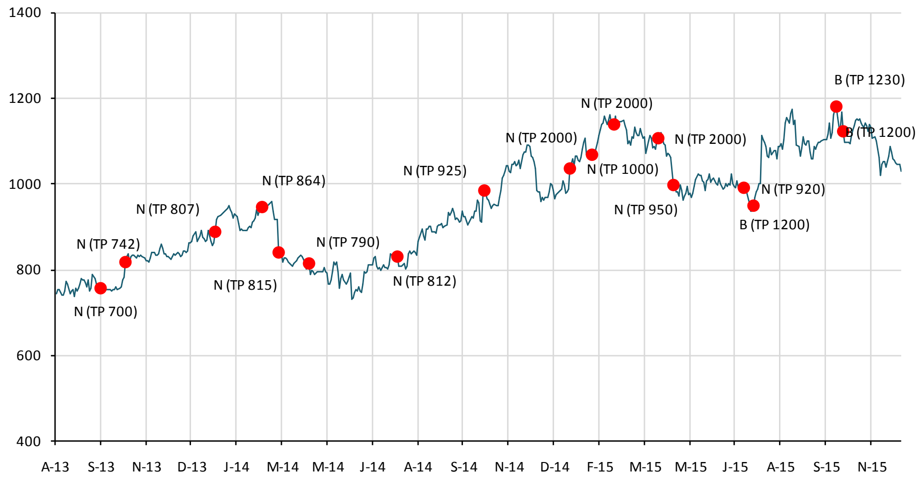
Cash Flow

Y/E Mar, Rs mn	FY15	FY16E	FY17E	FY18E
Pre-tax profit	3,900	4,040	4,588	5,120
Depreciation	939	935	1,037	1,129
Chg in working capital	-191	-523	-363	-225
Total tax paid	-1,049	-1,227	-1,262	-1,408
Other operating activities	0	0	0	0
Cash flow from operating activities	**3,598**	**3,225**	**4,000**	**4,616**
Capital expenditure	-669	-1,462	-1,500	-1,500
Chg in investments	-1,395	-1,000	-1,000	-1,000
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-2,064**	**-2,462**	**-2,500**	**-2,500**
Free cash flow	1,534	763	1,500	2,116
Equity raised/(repaid)	400	0	0	0
Debt raised/(repaid)	0	0	0	0
Dividend (incl. tax)	-1,405	-692	-783	-874
Other financing activities	-70	-33	0	0
Cash flow from financing activities	**-1,075**	**-725**	**-783**	**-874**
Net chg in cash	460	38	717	1,243

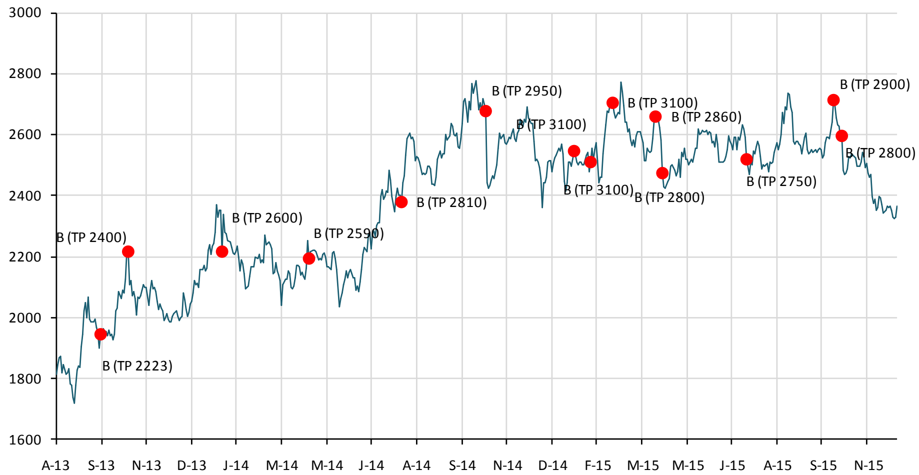
Valuation Ratios

	FY15	FY16E	FY17E	FY18E
Per Share data				
EPS (INR)	36.3	36.7	41.6	46.4
Growth, %	16.6	1.1	13.2	11.6
Book NAV/share (INR)	175.7	203.4	235.2	270.6
CFPS (INR)	39.2	33.9	40.6	44.2
DPS (INR)	15.0	7.4	8.4	9.3
Return ratios				
Return on assets (%)	17.5	15.4	15.4	15.1
Return on equity (%)	20.7	18.1	17.7	17.1
Return on capital employed (%)	19.5	17.2	17.1	16.8
Turnover ratios				
Asset turnover (x)	2.6	2.7	2.7	2.7
Sales/Total assets (x)	1.1	1.1	1.1	1.1
Sales/Net FA (x)	4.5	5.0	4.9	4.9
Working capital/Sales (x)	0.2	0.2	0.2	0.2
Receivable days	69.2	70.4	69.0	69.7
Liquidity ratios				
Current ratio (x)	3.7	3.5	3.9	4.1
Quick ratio (x)	3.7	3.5	3.9	4.1
Dividend cover (x)	2.4	5.0	5.0	5.0
Net debt/Equity (%)	(10.1)	(8.9)	(11.5)	(15.8)
Valuation				
PER (x)	18.4	18.2	16.0	14.4
PEG (x) - y-o-y growth	1.1	16.1	1.2	1.2
Price/Book (x)	3.8	3.3	2.8	2.5
Yield (%)	2.3	1.1	1.3	1.4
EV/Net sales (x)	2.7	2.4	2.1	1.9
EV/EBITDA (x)	13.3	12.4	11.3	10.0
EV/EBIT (x)	17.5	16.0	14.6	12.9

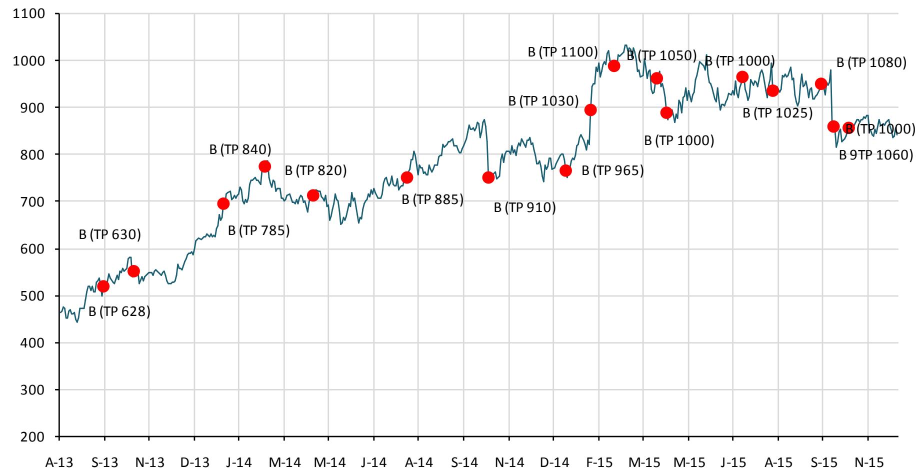
Stock Price, Price Target and Rating History (Infosys)



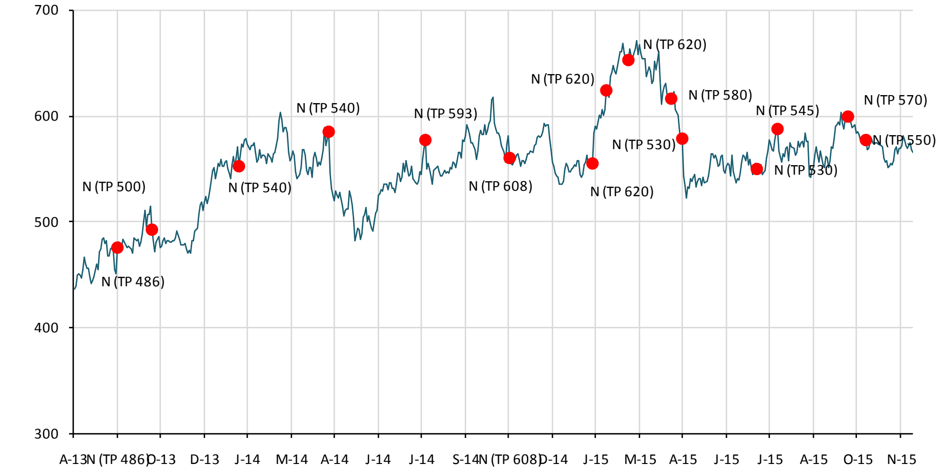
Stock Price, Price Target and Rating History (TCS)



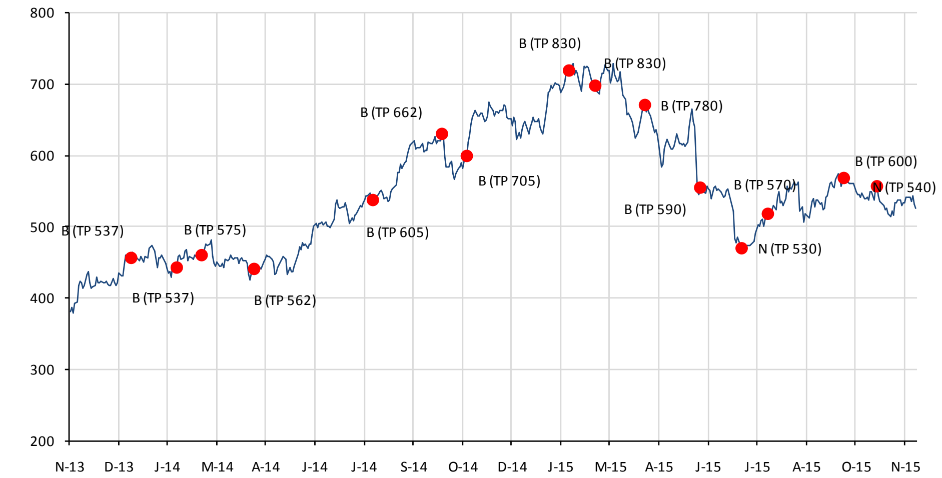
Stock Price, Price Target and Rating History (HCL Technologies)



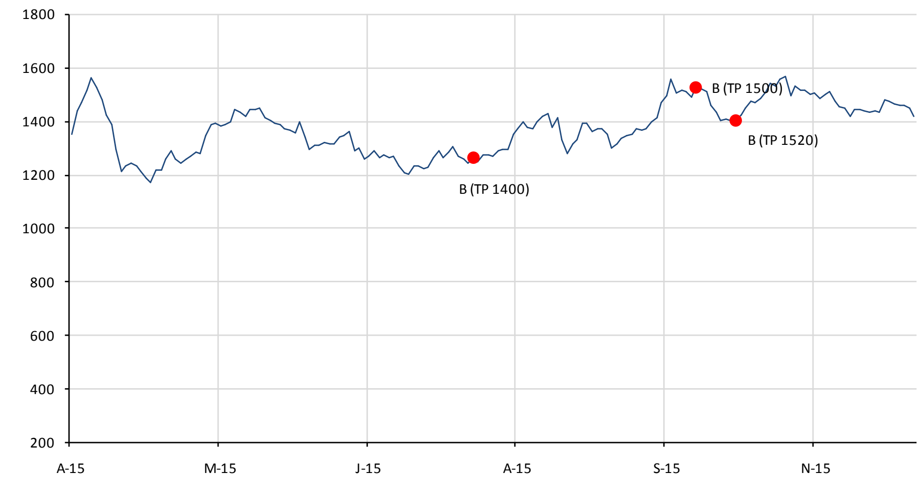
Stock Price, Price Target and Rating History (Wipro)



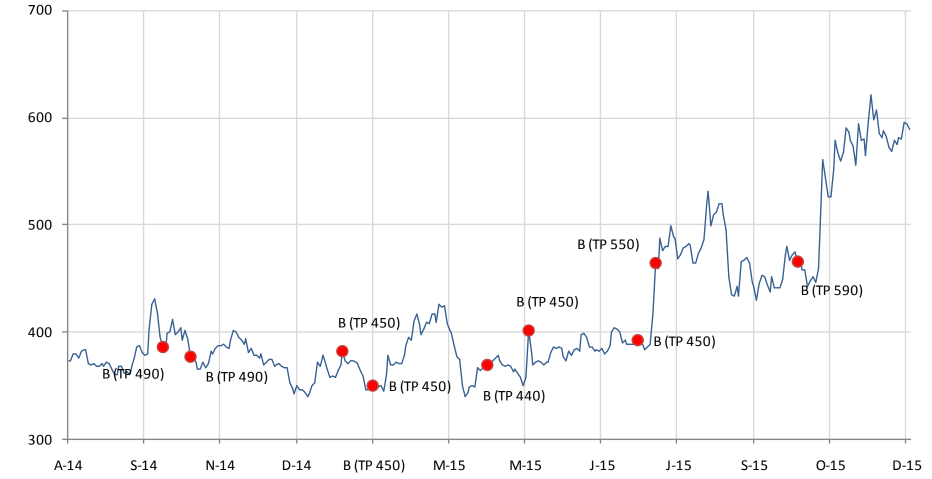
Stock Price, Price Target and Rating History (Tech Mahindra)



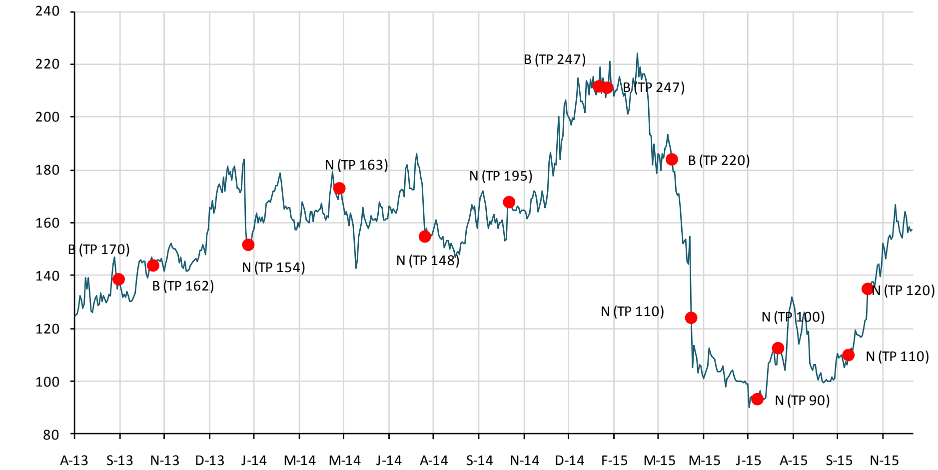
Stock Price, Price Target and Rating History (Mindtree)



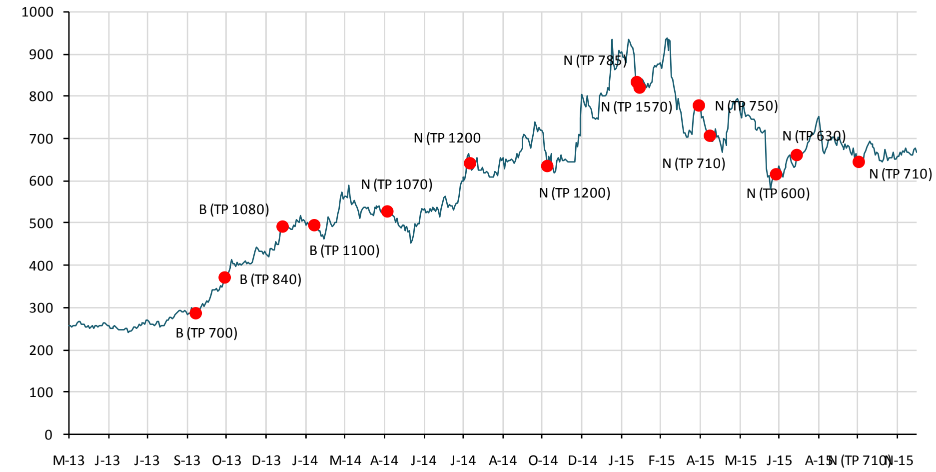
Stock Price, Price Target and Rating History (NIIT Tech)



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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