INSTITUTIONAL EQUITY RESEARCH

PhillipCapital

IT Services

Time to buy the sector? NOT YET!

6 December 2016

INDIA | IT SERVICES | Sector Update

Over the last one year, ALL IT companies and the CNX-IT have massively underperformed the broader index. The sector has seen particularly sharp corrections following events like Brexit (CNX-IT fell by 2.5% the following day) and US elections results (CNX-IT fell by 2.9% the following three days); coupled with lacklustre IT company results and guidance cuts, almost all stocks fell significantly over the last 12 months, and are trading close to historically low valuations.

The most prevalent question now is – is it time to buy the sector again? Is the worst behind us? If it isn't, is it already priced into current valuations? We do NOT see any material upside in most sector stocks over the next few quarters, DESPITE rock-bottom valuations. In fact, we believe valuations might fall from even current low levels for most companies and the overall sector – and might (at best) remain stagnant for others. In other words, it is not YET time to start buying the sector.

Why are current valuations justified?

It is now well accepted that none of the Indian IT services companies will be able to report double-digit growth in FY17 and (at least few years) beyond. In comparison, global new-age technology companies (salesforce.com, Netflix, Facebook, Twitter, LinkedIn) and companies that have reinvented themselves (Apple, Amazon, Google, Microsoft), are reporting staggering +20% growth in their businesses. Hence, we see no reason for a global or domestic, technology or diversified fund to invest in Indian IT services companies when there are much better options available.

Technology is a highly disruptive sector (unlike FMCG), where large global companies have gone bust (details inside) only because they became stagnant and were not able to adapt to a changing technology landscape. We fear the same for Indian IT companies. Their historical success in adopting new technology and gaining market share within it, does not guarantee an encore. Even if history repeats itself, Indian IT companies have always grown in the laggard/maturity phase of any technology adoption cycle – a phase that appears at least 4-6 quarters away. Until then, the struggle for Indian IT companies will persist.

Lastly, increasing global macro uncertainties on events such as the US election's surprising result and Brexit will lead to lower business visibility for enterprises across the world and directly influence the demand scenario for IT services companies. This will keep investors away from these companies for the next few quarters, implying no rerating.

So when do we start buying the sector again?

We have tried to put together a few metrics that could serve as leading indicators of when Indian IT companies would have turned the corner and could possibly grow again:

- When we (the market) start acknowledging that growth in every year will decelerate and NOT accelerate over the last year
- When we start seeing formal RFPs in the digital space
- When companies' digital segment become big enough to be reported as separate segment with break-up
- When the share of new deals is significantly greater than renewal deals

Maintain our Underweight call on the sector; downgrade multiples across the sector

As of now, we see the IT services sector (at best), as a short-term trading play – where investors can temporarily benefit from the relatively higher comfort (demonetisation impact) and depreciating INR. We see no fundamental reason to buy the sector, YET.

In this report, we introduce FY19 estimates, update our USD-INR assumption, and roll forward our valuations to average of FY18-19 earnings. We do not expect any company to report double-digit USD revenue growth in FY18/19. We also downgrade our valuation multiples for most stocks on macro uncertainties and lower visibility of FY19 estimates.

We downgrade TCS to SELL on its unfavourable risk-reward profile at current valuations and maintain SELL on Wipro and MindTree. Infosys remains our only conviction BUY.

Sector weight: UW

Companies

TCS	
Reco	SELL (↓)
CMP, Rs	2190
Target Price, Rs	2010
Infosys	
Reco	BUY (↔)
CMP, Rs	960
Target Price, Rs	1130
HCL Tech	
Reco	NEUTRAL (↔)
CMP, Rs	793
Target Price, Rs	840
Wipro	
Reco	SELL (↔)
CMP, Rs	457
Target Price, Rs	430
Tech Mahindra	
Reco	NEUTRAL (↔)
CMP, Rs	462
Target Price, Rs	430
MindTree	
Reco	SELL (↔)
CMP, Rs	449
Target Price, Rs	410
Persistent Systems	
Reco	SELL (↔)
CMP, Rs	594
Target Price, Rs	540
KPIT Technologies	
Reco	SELL (↔)
CMP, Rs	132
Target Price, Rs	120
NIIT Technologies	
Reco	BUY (↔)
CMP, Rs	420
Target Price, Rs	500

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Companies

We called it out early, and have been reiterating

Read our 'First law of thermodynamics' report **here**

In December 2015, we downgraded the IT sector on the back of its inefficient capital allocation policies (that it followed over the last decade), which we believed would cause these companies to be laggards in the digital transformation cycle – a manifestation of the 'first law of thermodynamics'. We were one of the first brokers to downgrade the sector, and our calls have played out to perfection.

Almost as if taking a cue from our report, many IT services companies have embarked upon an acquisition spree over the last few quarters making amends to their inefficient capital allocation policy. HCL Tech and Wipro have been particularly aggressive and have acquired companies with cutting-edge delivery capabilities in the digital space. While this development elates us, we believe it has come too late to be able to mitigate decelerating-to-declining growth in the industry – at least for the next few years.

Utilisation of the OCF generated over the last decade

Rs mn	TCS	Infosys	Wipro	HCL Tech	Total
OCF	8,66,621	5,81,590	4,34,505	2,68,958	21,51,674
FCF	6,91,968	4,21,710	3,24,332	2,00,147	16,38,157
Dividend	4,34,687	2,40,310	1,42,558	90,833	9,08,387
Capex	1,74,652	1,59,880	1,04,468	67,693	5,06,694
Cash added	1,95,216	2,85,140	1,55,643	97,991	7,33,990
Acquisitions	41,955	37,030	74,114	37,846	1,90,944
	TCS	Infosys	Wipro	HCL Tech	Total
Dividend Pay-out 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%

Read our 'Second law of thermodynamics' report **here**

In our second report of the 'thermodynamic series' (August 2016) we reiterated our Underweight call based on the sector, on the rise of right-wing extremism in the political landscape across the globe (which we represented as increasing entropy of the universe – a manifestation of the second law of thermodynamics). Our argument was that the rise of right-wing populism in the form of unabashed, xenophobic nationalism would lead to higher business uncertainty across the world, directly impacting the demand environment of Indian IT companies over the next few years.

Earlier this month, Donald Trump, the champion of right-wing extremism in the US, was elected the country's 45th president. Key elements of his election manifesto were bringing jobs back to the US by reducing outsourcing and curbing illegal immigrants from entering the US. Few months earlier, in an equally shocking development, majority of UK's citizens decided they want to exit the EU – again on similar grounds. These events have contributed significantly to the underperformance of the sector (as we had anticipated) and will continue to add incremental pressure on the growth of Indian IT companies, which are already grappling with cannibalization of their traditional revenue streams by new-age digital technology.

IT services companies – significant impact on near- and long-term growth and valuation

Source: PhillipCapital India Research

Current rally not sustainable

Two significant events occurred (coincidentally) on 9th November, 2016 – demonetisation by the Indian government and Donald Trump elected the 45th president of the United States. The impact of these events has pitched the Indian equity markets into turmoil over the last month, within which the IT sector gained 5% versus a 3% fall in the Nifty. We see this outperformance – a deviation from the trend of the last eighteen months – as temporary, and expect this rally to fizzle out soon.

1. Demonetisation is dwarfing the Trump factor

The election of Donald Trump is significantly negative for the Indian IT services sector. His focus on policies to curb immigration and create more jobs for locals, is likely to hit the business models of Indian IT companies hard – forcing them to hire more locals, thereby impacting their margins and earnings.

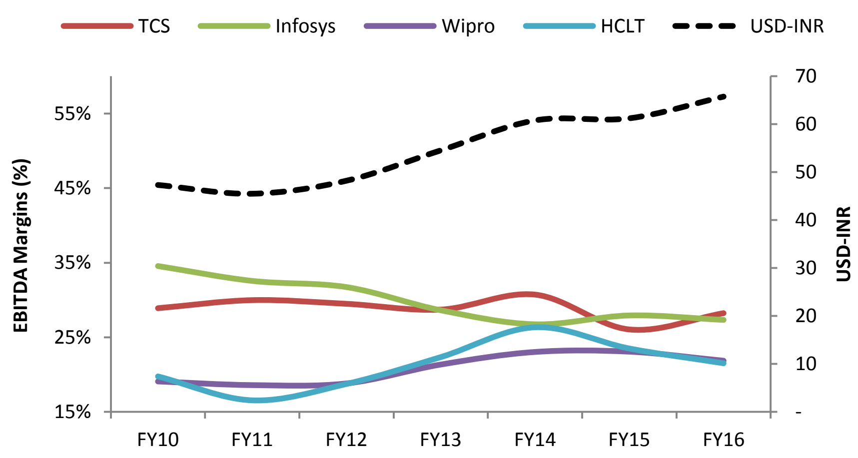
However, demonetisation (announced on the same day) dwarfed Trump's negative impact. IT services will be least impacted by demonetisation – infact we see ZERO impact. This led to investors flocking to buy the sector's stocks as other sectors (like FMCG, auto, real estate), are expected to be significantly impacted.

We believe that had demonetisation NOT been announced, IT services stocks would have reacted in completely the opposite manner. It is also important to note that demonetisation has NOT changed the fundamentals of the sector – in fact, if at all, the other event on the same day (Trump win), assures more headwinds for the sector in the medium- to long -term.

2. INR depreciation only helps topline; margins unlikely to expand

IT stocks have also run-up, as a response to 4% depreciation in USD-INR, over the last month. While the INR depreciation will definitely boost INR revenues, we do not expect any boost to margins. Over the last few years, enterprises have started asking for the benefits of currency fluctuations to be passed onto them – leaving little scope for margin expansion for vendors. In fact, over the last five years, while INR has depreciated by 50%, the margins for top-4 IT companies have declined, or at best, remained stable.

Top-5 IT Services companies haven't gained much from INR depreciation



Source: Bloomberg, PhillipCapital India Research

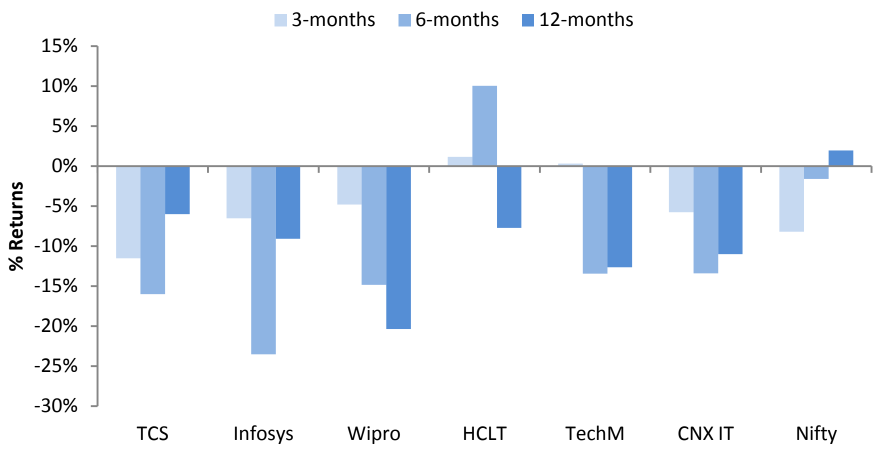
While we acknowledge a minor temporary boost to the earnings because of INR depreciation, we do not see the sector's fundamentals improving one bit, and expect underperformance to continue over the next five quarters.

On the back of these factors, we see the IT Services sector, at best, as a short term trading play – where investors can temporarily benefit from relatively higher levels of comfort (demonetisation impact) and depreciating INR. Fundamentally, as we establish in the next section, there is NO reason, YET, to buy the sector.

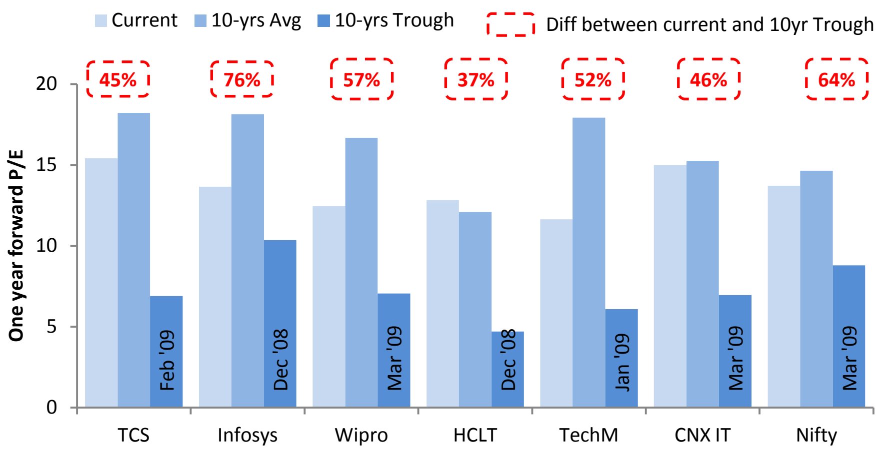
Time to buy the sector? NOT YET!

Over the last year (since we downgraded the sector), *all* IT companies along with the CNX-IT Index massively underperformed the broader index. The sector has seen particularly sharp corrections following events such as Brexit (CNX-IT fell 2.5% the following day) and the election of Trump as the US president (CNX-IT fell by 2.9% in the following three days). That coupled with lacklustre results by IT companies and guidance cuts led to almost all stocks correcting significantly over the last 12 months; they are now trading close to historical trough valuations.

IT sector has significantly underperformed the broader index



Current valuations are not far from historical trough valuations



Source: Bloomberg, PhillipCapital India Research

The most prevalent question now is – is it time to buy the sector again? Is the worst behind us? Even if it isn't, is it already priced into current rock-bottom valuations?

We do NOT see any material upside in most sector stocks over the next few quarters, DESPITE rock-bottom valuations. In this report, we try to reason why valuations might still fall from current levels for most companies and the overall sector – and might (at best) remain stagnant for few others. In other words, it is not YET time to start buying or increasing the weight of the sector.

We do NOT see any material upside in most sector stocks over the next few quarters, DESPITE rock-bottom valuations.

We also try to devise few metrics that investors can track, and which could be leading indicators of a turnaround in the sector – a signal for buying the sector again!

Why current valuations are justified, and in fact may fall further...

As the charts on the last pages depict, Indian IT Services companies have massively underperformed the broader index over the last 12 months and are now trading close to their trough valuations. However, we find current valuations justified; worse, we expect these to fall further for most companies and the overall sector, and at best to remain stagnant for few other stocks. We have FIVE rock-solid reasons backing our theory.

1. Global technology companies are growing faster

It is now clear that none of the Indian IT services companies will be able to report double-digit USD revenue growth in FY17. With their traditional business streams cannibalized by new-age digital technology, where Indian companies are not able to grab market share, it is safe to assume that these companies won't be able to report double-digit over the next two years too – at the very least!

Compare that with the staggering +20% business growth that new-age technology companies (salesforce.com, Netflix, Facebook, twitter, LinkedIn) and companies that have reinvented themselves (like Apple, Amazon, Google, Microsoft) are reporting.

Global technology companies are expected to continue growing at staggering pace

	MKt Cap	Rev growth			EBITDA growth			PAT growth			EV/Sales		EV/EBITDA		P/E	
	($Bn)	CY12-15	CY16E	CY17E	CY12-15	CY16E	CY17E	CY12-15	CY16E	CY17E	CY17	CY18	CY17	CY18	CY17	CY18
Facebook	349.2	52%	52%	34%	90%	116%	30%	386%	228%	30%	9.0	7.2	14	11	23	18
Twitter	13.0	91%	15%	10%	211%	-625%	18%	87%	-171%	23%	4.0	3.6	13	11	30	24
LinkedIn	26.4	45%	26%	20%	25%	322%	21%	-297%	-407%	27%	5.4	4.6	18	15	40	32
Google	537.2	14%	-3%	17%	16%	45%	17%	15%	47%	20%	5.5	4.7	11	10	19	16
Salesforce	50.8	30%	26%	21%	82%	167%	29%	-44%	-1543%	41%	4.9	4.1	22	19	57	44
Netflix	50.4	23%	30%	25%	57%	60%	75%	93%	144%	93%	4.6	3.8	49	31	94	52
Amazon	362.3	21%	28%	23%	44%	79%	32%	-348%	706%	44%	2.1	1.8	18	14	54	37
Alibaba	1,631.4	43%	51%	30%	45%	97%	23%	103%	-21%	28%	7.8	6.2	18	14	24	19
IBM	155.5	-8%	-2%	0%	-9%	-2%	9%	-7%	-2%	1%	2.3	2.3	9	9	12	11
Apple	594.3	8%	6%	6%	8%	2%	6%	7%	4%	6%	1.8	1.8	6	6	11	11
Microsoft	475.0	3%	10%	6%	-4%	33%	8%	-8%	36%	8%	4.2	3.9	11	10	19	17
TCS*	66.5	20%	10%	9%	19%	7%	6%	20%	7%	6%	1.7	1.6	13	12	17	16
Infosys*	33.3	16%	11%	12%	14%	10%	13%	13%	7%	14%	2.2	1.9	10	8	15	13

Source: Bloomberg (*PC estimates for TCS and Infosys – INR growth, CY16E = FY17E)

For a global technology or diversified fund, these new-age technology companies offer much better growth prospects than struggling Indian IT services companies. True that many of these 'start-ups' are not profitable right now, but such is the nature of the technology industry – profitability improves only AFTER you secure growth. In any case, the industry is going through a disruption – new technology is replacing old technology faster than anyone imagined. In such an environment, companies are valued on EV/sales multiples, or other creative metrics like Value/user or Revenue/user.

For a global technology or diversified fund, new-age technology companies offer much better growth prospects than struggling Indian IT services companies

For an India-based diversified fund, there are many more sectors (cement, industrials, infrastructure, auto) that are likely to provide strong growth over the next few years, driven by domestic demand and activity. IT sector, driven by global macro-environment and technology disruption, offers an unattractive investment option for the next two years at least.

For an India-based diversified fund, sectors such as cement, industrials, infrastructure, and auto are likely to provide strong growth driven by domestic demand and activity

Comparison with the FMCG industry

A common argument justifying a rerating for the IT sector is the current valuation of the Indian FMCG sector. FMCG companies, which have been (and are expected to) reporting low-single-digit volume growth (or decline in some cases), are trading at highly expensive valuations (30-40x P/E one-year forward). These companies have high ROEs (30-50%) but so do many Indian IT companies (TCS, Infosys, HCL).

Indian FMCG companies, though stagnant, still trading at much higher multiples

	CMP	MKt Cap	Rev growth			EBITDA growth			PAT growth			ROE		EV/Sales		P/E	
	Rs	Rs bn	FY13-16	FY17E	FY18E	FY13-16	FY17E	FY18E	FY13-16	FY17E	FY18E	FY17E	FY18E	FY17E	FY18E	FY17E	FY18E
HUL	849	1,837	7%	5%	12%	12%	6%	14%	2%	9%	14%	117	119	5.2	4.7	41	36
Nestle	6,272	605	-1%	16%	15%	-4%	22%	18%	-19%	104%	21%	41	44	6.2	5.4	52	44
Britannia	3,001	360	12%	12%	15%	43%	11%	20%	46%	15%	20%	42	40	3.7	3.2	39	32
Asian Paints	967	927	12%	10%	16%	17%	15%	17%	16%	21%	19%	34	34	5.4	4.6	44	38
GCPL	1,450	494	12%	11%	14%	17%	17%	16%	12%	19%	18%	24	23	5.1	4.5	37	32
TCS*	2,190	4,315	20%	10%	9%	19%	7%	6%	20%	7%	6%	30	27	3.5	3.2	17	16
Infosys*	960	2,194	16%	11%	12%	14%	10%	13%	13%	7%	14%	21	21	2.6	2.2	15	13
Wipro*	457	1,124	11%	8%	5%	11%	-1%	5%	10%	-3%	8%	17	16	1.7	1.6	13	12
HCL Tech*	793	1,120	17%	9%	13%	16%	14%	14%	21%	10%	12%	25	25	2.2	1.9	14	13

Source: Bloomberg (*PC estimates for TCS, Infosys, HCL and Wipro)

However, unlike FMCG, the IT industry is highly disruptive – where the product and services profiles change every 3-5 years, quite often driving the earlier technology obsolete. FMCG has hardly seen any disruption over the last five decades (apart from a minor introduction of modern trade) – the composition of 'soap' has been the same for decades; edible items such as milk, biscuits, and chips have only seen packaging changes.

Unlike FMCG, the IT industry is highly disruptive – where the product and services profiles change every 3-5 years, quite often while driving the earlier technology obsolete

So while an FMCG company (like say HUL) can survive and hold on to its market share even in a declining growth environment, a technology company (like TCS or Wipro), that does not adapt to the changing technology environment, may well go out of business in few years. Over the last five years, we have seen companies like Kodak, Nokia, and Blackberry – once leaders in their domains – become obsolete due to their failure to adapt to new and changing technology.

Global tech companies that went bust or were significantly impaired

DOT COM Bubble	Digital/Mobility	Others
AOL	Blackberry	Sun Microsystems
Books-a-million	Kodak	Sperry Univac
broadcast.com	Nokia	Honeywell
GovWorks.com	Yahoo	Control Data
Lycos	Compaq	Digital Equipment Corp
Open.com	Blockbuster	Wang
Startups.com		Data General
Xcelera.com (XLA)		Polaroid
theGlobe.com		Lucent
Lastminute.com		Nortel
Startups.com		Borland

Source: PhillipCapital India Research

Read our thoughts recently echoed by Mr. Vineet Nayar, ex-CEO, HCL Tech **here**

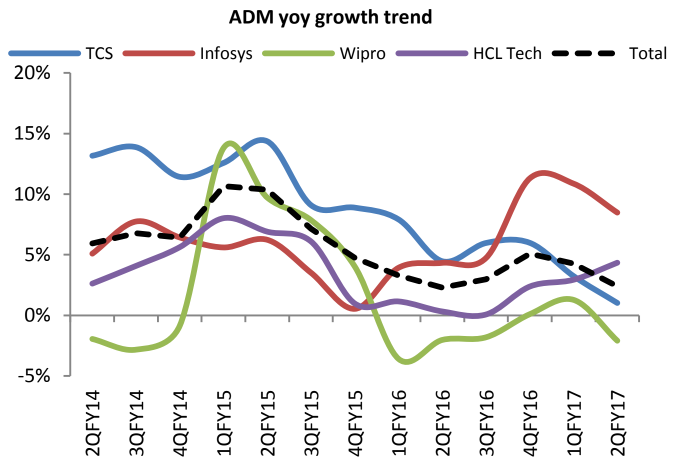
We derive an important conclusion here – while the multiple to value IT companies might be earnings (P/E), the magnitude of the multiple will ALWAYS be driven by its topline growth. A 'stagnant technology company' cannot exist for long! Hence we see no reason for a global or domestic, technology or diversified fund to invest in Indian IT services companies when they have much better options to invest (global or domestic) and when they cannot ascertain the future of Indian IT services companies. The reasons stated above will keep investors away from Indian IT services companies for the next few quarters, implying no rerating; in fact, there could be further downside from current levels for few companies.

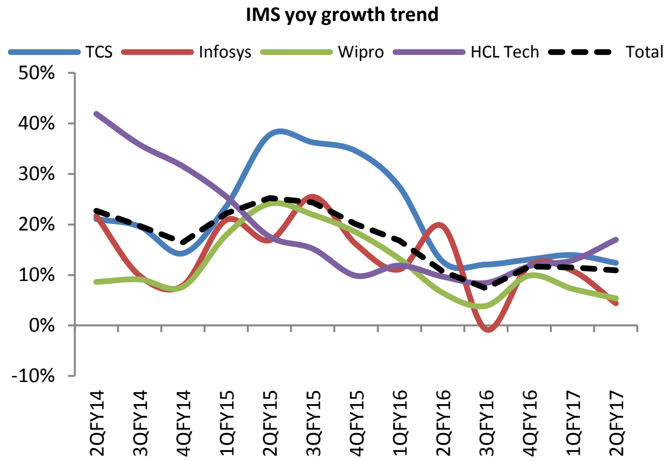
A 'stagnant technology company' cannot exist for long!

2. No rerating in a decelerating-to-declining environment

There is no longer any doubt that we are in a decelerating environment for IT services companies. Most of them reported their peak incremental revenue addition (in absolute as well as percentage terms) in FY15, and growth has been declining ever since for reasons well known – cannibalization of their traditional revenue streams by new-age digital technology streams, where Indian IT companies are unable to grab significant market share.

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





Source: Companies, PhillipCapital India Research

Second derivative analysis also points to deceleration in ADM/IMS

ADM	3QFY15	4QFY15	1QFY16	2QFY16	3QFY16	4QFY16	1QFY17	2QFY17	No of quarters with -ve d^2Y/dX^2	% of quarters with -ve d^2Y/dX^2
TCS	-34.5%	-22.2%	-37.0%	-68.8%	-34.3%	-32.6%	-59.0%	-76.8%	8	**100%**
Infosys	-54.6%	-91.6%	-29.9%	-30.5%	34.8%	1986.5%	176.5%	95.7%	4	**50%**
Wipro	-376.9%	-573.2%	-126.0%	-120.9%	-123.1%	-97.7%	-135.4%	3.2%	7	**88%**
HCL Tech	49.1%	-82.5%	-85.6%	-95.2%	-98.6%	142.5%	154.2%	1213.2%	4	**50%**
IMS	**3QFY15**	**4QFY15**	**1QFY16**	**2QFY16**	**3QFY16**	**4QFY16**	**1QFY17**	**2QFY17**	**No of quarters with -ve d^2Y/dX^2**	**% of quarters with -ve d^2Y/dX^2**
TCS	84.9%	141.8%	16.5%	-66.4%	-66.7%	-62.1%	-49.2%	-2.1%	5	**63%**
Infosys	158.0%	102.6%	-46.8%	16.5%	-102.9%	-26.1%	-2.4%	-77.5%	5	**63%**
Wipro	140.8%	141.4%	-26.2%	-73.3%	-82.4%	-46.5%	-45.2%	-17.0%	6	**75%**
HCL Tech	-57.6%	-68.8%	-53.6%	-45.1%	-44.7%	19.5%	8.8%	75.8%	5	**63%**

Source: Companies, PhillipCapital India Research

Constant currency growth numbers convey the same message

Segment	3QFY15	4QFY15	1QFY16	2QFY16	3QFY16	4QFY16	1QFY17	2QFY17	No of quarters with -ve d^2Y/dX^2	% of quarters with -ve d^2Y/dX^2
ADM for TCS	-34.5%	-22.2%	12.9%	-28.2%	12.2%	-6.6%	-65.5%	-75.7%	6	**75%**
IMS for HCL	-57.6%	-68.8%	-24.0%	-7.3%	-11.8%	42.6%	-27.2%	84.0%	6	**75%**

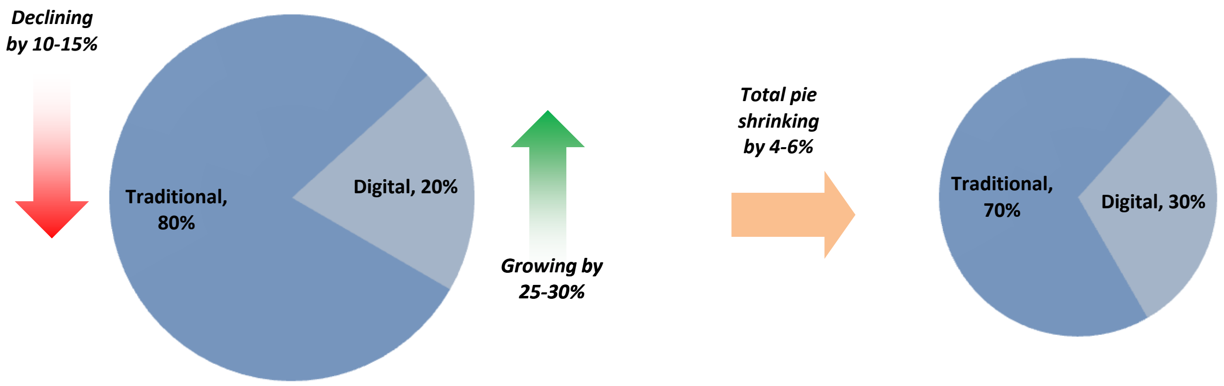
Source: Companies, PhillipCapital India Research

As per our research, traditional outsourcing deals (including ADM, IMS, and enterprise) are currently being renewed at a 25-30% discount to their earlier value. While companies can compensate part of this through automation and other operational efficiencies, there is a significant decline in this large pie, which still constitutes more than 75-80% of the overall business.

Traditional outsourcing deals are currently being renewed at 25-30% discount to their earlier value

On the other hand, digital forms only 15-18% of business for most IT companies (excluding MindTree at 38%), assuming it represents "true digital" business (which remains ambiguous). Even if this small digital pie grows at its current rate of more than 25% yoy, growth will not be sufficient to compensate for the decline in the traditional stream.

Traditional and digital revenue pie transformation over next few years



Source: PhillipCapital India Research

As the traditional pie of the business erodes, its share in revenues and its drag on revenue growth will decline. However, at the same time, the digital pie will not be able to grow by the erstwhile +20% rate due to its larger size and higher competitive intensity. The net impact will be that Indian IT companies will move from decelerating to declining growth profile – over the next few quarters.

In a declining growth environment, we do not expect sector valuations to rerate. In such an environment, companies will only get multiples for growth that their cash-on-books will be able to generate – which is surely not higher than the current multiple the sector is trading at.

3. History suggests, but does not guarantee, that Indian companies will be able to adapt

To be fair, this is not the first time that Indian IT companies are facing a technology disruption. While the Indian IT outsourcing industry was born out of the maintenance requirements of the mainframe systems, technology disruptions like Y2K, RIMS, thin client architecture, and the most recent, cloud adoption, have posed existential threats to Indian IT companies in the past. Every one of those times, Indian IT companies have adopted the new technology quickly, and grabbed market share over a period.

Technology disruptions like Y2K, RIMS, thin client architecture, and the most recent, cloud adoption, have posed existential threats to Indian IT companies in the past.

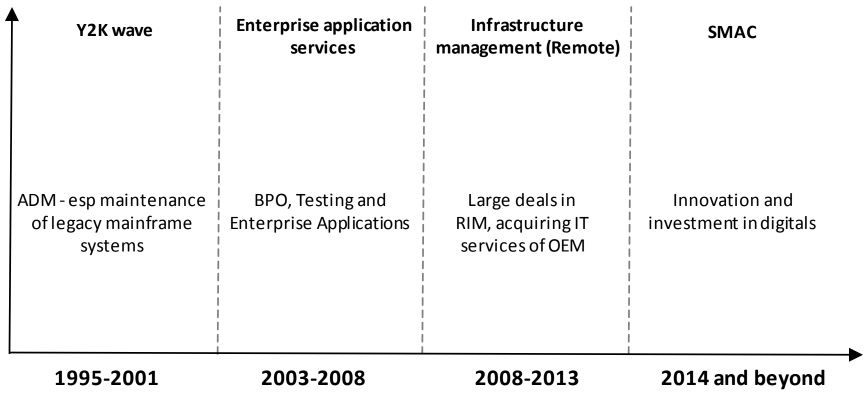
However, in case of technology adoption, past accomplishments cannot guarantee future successes, especially when we have examples of leading global companies going bust due to their failure to adapt to the evolving technology landscape. While we are confident of the capability of the Indian IT vendors to adapt and reinvent themselves over a period, we remain sceptical on two accounts:

We don't know what stage of the digital-adoption cycle we are in – hence when will these laggards come into focus?

Indian IT companies have historically come in to the picture towards the later stage of any technology wave. Whether it was the maintenance of the legacy COBOL-based banking platforms, 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 (the most lucrative one) and Indian IT companies have gradually developed capabilities in those domains, capturing large share in the mature phase.

Indian IT companies have historically come towards the later stage of any technology wave.

Waves of the global IT industry

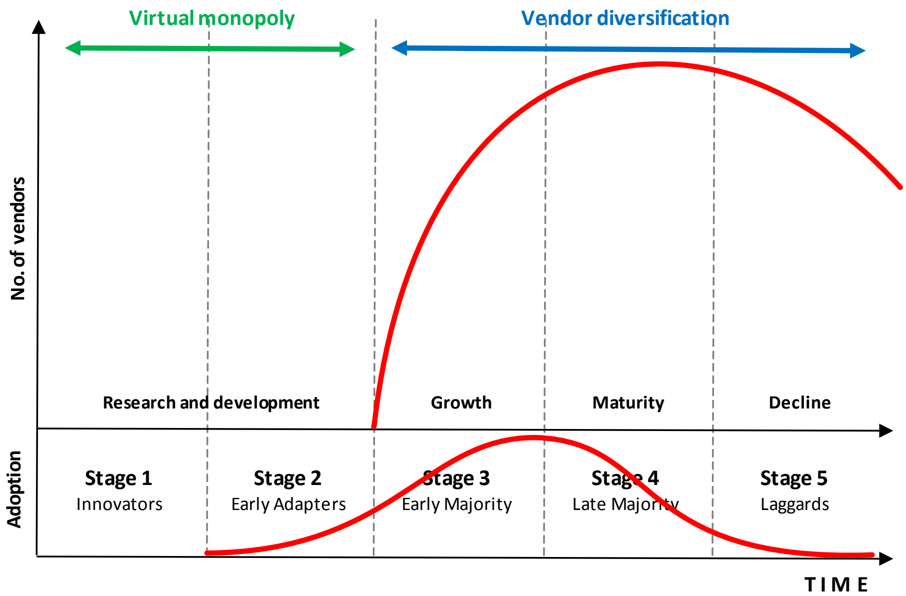


Part of the reason for Indian companies coming in 'late' is that during the 'early adapters' phase of any technology disruption, vendor consolidation is virtually a given thing. Enterprises do not want to spread themselves across multiple vendors in a relatively new technology domain. However, as a domain reaches maturity, enterprises start searching for cost-optimisation benefits, leading to vendor diversification. This is where the Indian IT companies jump in with their outsourcing proposition.

However, the problem with any technology disruption, just like the current digital one, is the ambiguity surrounding the timing of the individual phases. Digital technology has surely NOT YET reached the maturity stage (technology is still evolving, no formal RFPs) – but how quickly will it reach there is anybody's guess. Moreover, that timing becomes critical from the Indian IT companies' perspective, as they will not be able to see sustainable growth unless digital reaches maturity stage.

Digital technology has surely NOT YET reached the maturity stage (technology is still evolving, no formal rfps) – but how quickly will it reach there is anybody's guess.

Vendor diversification: Usually in the later stage of technology-adoption cycles



Source: PhillipCapital India Research

Base so big that turning around (and becoming one of them) will be highly difficult

In past technology disruptions, Indian IT companies were able to reinvent themselves and adapt, as they were still quite nimble and small. They had a lean structure, which helped them turnaround quickly and develop delivery capabilities in new domains.

However, none of the technology evolutions before this were as disruptive as SMAC. This time round, the story seems to be quite different. Indian IT companies are no longer lean and nimble – they employ a whopping 3.5mn+ people and have a revenue base of US$ 1.4tn (10% market share of the global IT services industry excluding captives). Over 80% of their business constitutes traditional streams (like ADM, IMS), which are under threat from SMAC.

Size of companies during each tech disruption

Revenue (US$ mn)	FY03	FY08	FY14
TCS	1,075	5,698	13,443
Infosys	753	4,176	8,249
Wipro	860	3,647	6,618
HCLT	416	1,879	5,360
TechM	130	935	3,098

Source: PhillipCapital India Research

We remain sceptical about how much Indian IT companies would be able to reinvent themselves this time to come out on top again.

We remain sceptical about how much Indian IT companies would be able to reinvent themselves this time to come out on top again.

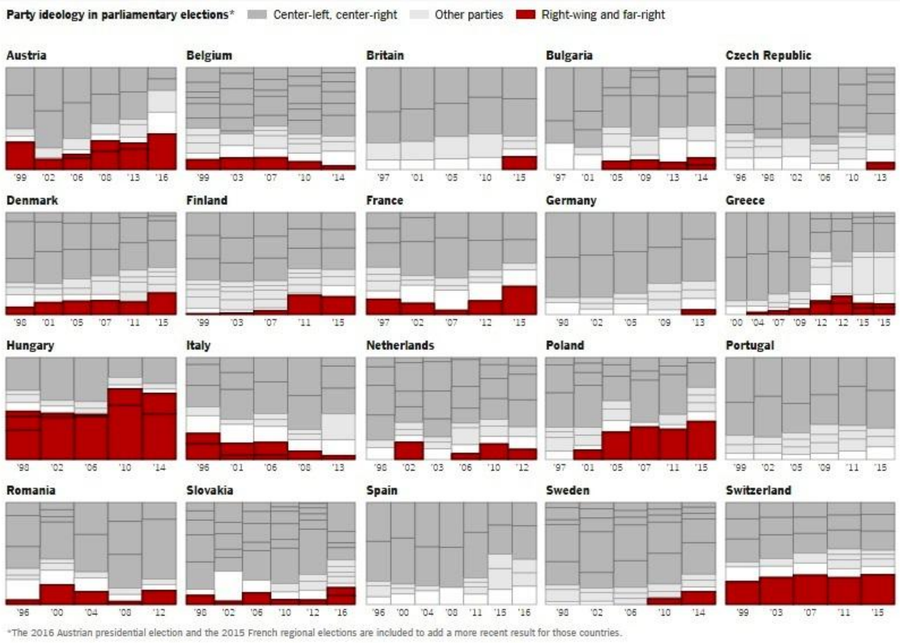
4. Increasing global uncertainty amidst rising right-wing populism

We had highlighted this factor in our August 2016 report – right after Brexit. Over the last few years, we have seen an unprecedented rise in the popularity of right-wing extremists across the globe (India, UK, US, Europe) leading to calls for more 'nationalistic' policies and an abandonment of globalisation practices. Events like the rise of Donald Trump in the US and the Brexit are testimonies of these voices gaining strength and support from policy makers. We view this as highly negative for the Indian IT sector, whose fate is intricately linked to the benefits of globalisation.

Consider the following events in reverse chronological order:

1) The champion of right wing extremism, Donald Trump, elected the 45th president of the US.
2) Brexit – where the primary arguments in favour of leaving were immigration and jobs for locals.
3) Rise in vote share of right-wing and far-right parties in various elections across Europe over the last fifteen years *(see exhibit below).*
4) Right-wing extremist party, BJP, accedes to power in India – it became the first party in the last 30 years to win a majority on its own.
5) Continued popularity of the Russian president Vladimir Putin and the Chinese President Xi Jinping – both have followed highly nationalistic agendas.

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



Source: NYTimes, PhillipCapital India Research

The rise of right-wing populism is likely to lead to the implementation of 'nationalistic' policies such as:

1) Forcing businesses to grow more locally than globally
2) Compelling companies to hire more locals than immigrants
3) Protecting jobs and industries from moving out of the country *(even though this would violate the economic principle of global competitive advantage)*

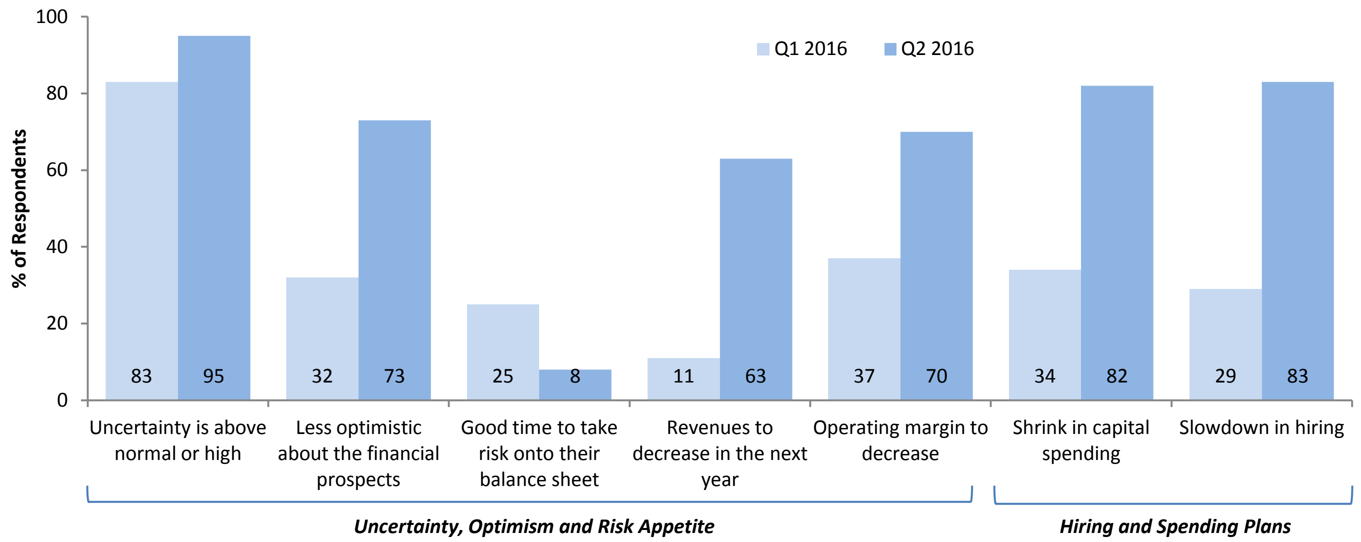
Enterprises would hold on to, push back, or postpone their investment decisions indefinitely

We see the support for these nationalistic policies leading to a rise in business uncertainty and a volatile environment. Support for these policies will also reduce visibility for enterprises and they would hold on to, push back, or postpone their investment decisions indefinitely. Case in point – the Deloitte Group surveyed 132 CFOs (from the UK) about business visibility after Brexit and their key findings were:

1) 82% said they expected their employers to reduce capital spending over the next year (vs. 34% in an earlier survey)
2) 83% predicted a slowdown in hiring (vs. 29%)
3) 95% said the level of uncertainty that their businesses are facing was above normal, high, or very high (vs. 83%)
4) 68% said they thought leaving the EU would cause long-term deterioration in UK's business environment

Read the Deloitte survey here

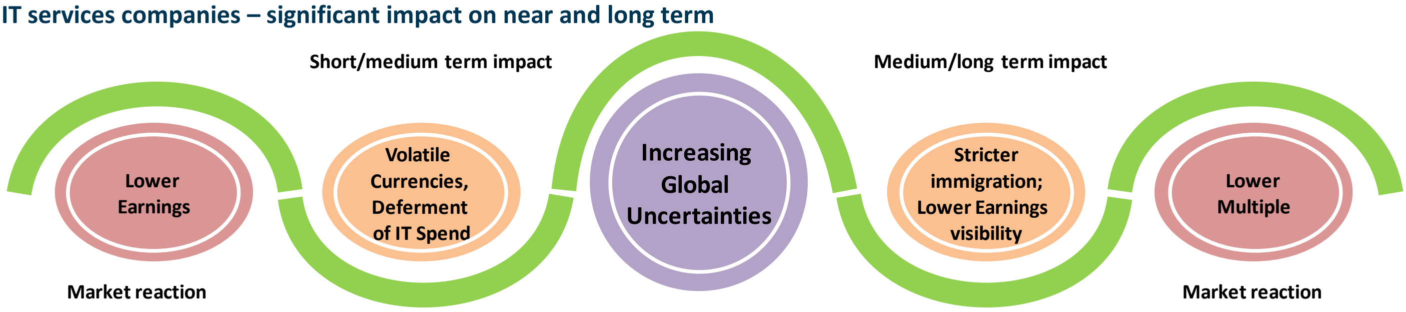
Deloitte's Q2-2016 survey points to higher business uncertainty amongst UK CFOs, especially after Brexit



Source: Deloitte

We believe that the rise of these extremist opinions will lead to lower business visibility for enterprises across the world– this would directly impact the demand scenario for IT services companies. We fear a two-pronged effect – (1) near-term currency volatility leading to a negative impact on earnings, (2) lower revenue visibility in the long-term leading to a de-rating of valuations.

IT services companies – significant impact on near and long term



Source: PhillipCapital India Research

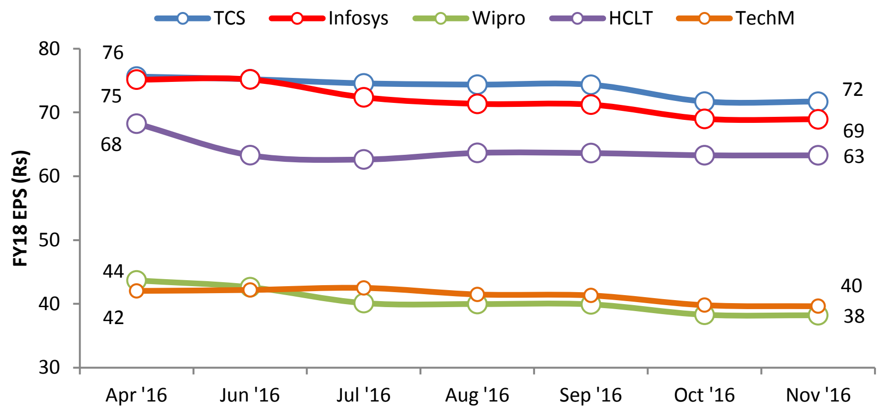
5. Consensus expectations – still baking in optimism

Despite multiple headwinds, both near and long term, consensus estimates still predict double-digit USD revenue growth for FY18 for the top-4 Indian IT services companies (except for Wipro). While FY17 estimates have come down after muted performance in 1HFY17, we believe FY18 estimates are in for a big reset. In our opinion, almost all top-5 Indian IT services companies will report single-digit organic growth in FY17 – ditto for FY18 and FY19.

Our estimates vs Consensus

			TCS	Infosys	Wipro	Hcl Tech	TechM	MindTree	Persistent	KPIT	NIIT Tech
Revenue	PC	FY18	13,03,235	776,186	582,960	531,915	316,070	58,396	31,731	35,464	30,700
Rs mn		FY19	13,91,775	853,485	613,204	569,277	337,901	63,100	33,999	37,400	32,916
	Consensus	FY18	13,09,696	761,358	596,896	526,518	319,071	58,149	33,246	35,913	30,006
		FY19	14,42,337	836,240	642,923	576,745	349,878	64,971	38,099	39,788	32,329
	Deviation	FY18	-0.5	1.9	-2.3	1.0	-0.9	0.4	-4.6	-1.2	2.3
		FY19	-3.5	2.1	-4.6	-1.3	-3.4	-2.9	-10.8	-6.0	1.8
EBITDA	PC	FY18	3,45,471	211,284	115,981	114,213	49,771	8,397	5,196	4,273	5,092
Rs mn		FY19	3,62,190	229,954	123,424	120,838	55,110	9,265	5,647	4,684	5,550
	Consensus	FY18	3,58,869	206,989	120,375	113,874	52,313	8,867	5,666	4,715	5,048
		FY19	3,93,843	227,977	128,710	124,153	58,350	10,261	6,773	5,762	5,490
	Deviation	FY18	-3.7	2.1	-3.7	0.3	-4.9	-5.3	-8.3	-9.4	0.9
		FY19	-8.0	0.9	-4.1	-2.7	-5.6	-9.7	-16.6	-18.7	1.1
PAT	PC	FY18	2,76,051	164,637	91,702	89,576	32,417	5,454	3,485	2,609	2,916
Rs mn		FY19	2,90,146	179,000	98,023	95,509	36,306	5,975	3,780	2,901	3,250
	Consensus	FY18	2,82,594	157,115	93,411	90,104	34,943	5,724	3,696	2,993	2,896
		FY19	3,14,414	173,166	102,607	98,193	39,353	6,758	4,483	3,624	3,218
	Deviation	FY18	-2.3	4.8	-1.8	-0.6	-7.2	-4.7	-5.7	-12.8	0.7
		FY19	-7.7	3.4	-4.5	-2.7	-7.7	-11.6	-15.7	-20.0	1.0

FY18 consensus estimates have come down gradually over last few quarters – we expect an encore for FY19 now



Source: PhillipCapital India Research; *TCS EPS is divided by 2 for better representation

Consensus estimates for FY18 have come down by 5-8% over the last six months – we expect a similar fate for FY19 estimates over the next twelve months

NASSCOM – finally downgrades guidance

After much reluctance and delay, Nasscom finally lowered its growth guidance for the Indian IT services industry to 8-10% from 10-12% earlier (in CC terms). While it was evident after 1QFY17 that none of the large-cap companies would be able to achieve that growth, 2QFY17 results reaffirmed that the industry couldn't achieve Nasscom's guidance – and finally it obliged in November 2016.

If we analyse the last few 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 its guidance. Nasscom's guidance over the years has moved from conservative, to realistic, to highly optimistic over the last few years.

Nasscom's guidance has moved from conservative to realistic to highly optimistic over the last few years

Nasscom's guidance trends

	FY12	FY13	FY14	FY15	FY16	FY17E
NASSCOM guidance	16-18%	11-14%	12-14%	13-15%	12-14%	8-10%
Industry growth	16.5%	10.2%	13.0%	13.0%	12.3%	-

Source: NASSCOM, Companies, PhillipCapital India Research

So when do we start buying the sector again?

The above analysis suggests that Indian IT companies are facing, and will continue to face, significant challenges over the next few quarters – keeping valuations depressed. However, we do not see this translating into a complete washout for these companies or obsolescence of their business models.

Indian IT companies are too big to become irrelevant

Indian IT services companies currently employ over 3.5mn people globally. They serve over 240 of the Fortune 500 companies in the world and their total list of clients far exceeds 1,000. Simply put, the world cannot do without them. 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

As we have stated earlier, Indian IT companies have historically come in towards the later stage of any technology 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). Conversely, Indian IT companies have gradually developed capabilities in those domains, capturing large share in the mature phase.

So how do we know that we have reached the maturity phase of the digital transformation cycle, and that it is time to buy Indian IT companies again? We have tried to put together a few metrics, which could serve as a lead indicators:

1. When we start acknowledging that growth in every year will decelerate and NOT accelerate over the last year

There is a trend that we (sell-side analysts) have followed over the last few years:

- **USD revenue growth in the current year = x%**
- **USD revenue growth in the next year = (x + y)% .... where y > 0**

Now this was a safe assumption as long as Indian IT companies were grabbing market share from global counterparts (IBM, Cap-Gemini), entering new geographies (Europe, Japan, APAC), and there was increasing outsourcing activity across the world.

However, over the last two years, we have seen a deceleration in revenues of Indian IT companies driven by cannibalisation of traditional business streams by the new-age digital technology, in which the Indian companies were not able to grab market share. First, we need to acknowledge this trend, and the outcome of this trend as deceleration in revenue growth.

However, if we look at consensus estimates we still see topline growth for FY18/19 is higher than FY17 – despite the fact that revenue growth for most companies is going to be lower in FY17 vs. FY16, and was lower in FY16 vs. FY15. Unless consensus accepts the reality – that we are in a decelerating-to-declining growth environment – and adjusts its estimates to capture the 'true' valuation that these stocks are trading at, we will remain quite far from the bottom.

Consensus estimates still point to acceleration in revenues

USD Revenue growth			Consensus estimates			PC estimates		
	FY15	FY16	FY17E	FY18E	FY19E	FY17E	FY18E	FY19E
TCS	15.0%	7.1%	9.5%	10.0%	10.5%	6.8%	6.9%	6.8%
Infosys	5.6%	9.1%	10.5%	10.1%	9.8%	8.1%	9.5%	10.0%
Wipro	5.2%	2.2%	8.3%	7.6%	7.9%	5.7%	4.9%	5.9%
HCL Tech	11.1%	7.1%	14.8%	12.2%	9.5%	11.4%	11.0%	7.0%
Tech Mahindra	18.3%	10.2%	9.3%	10.1%	10.5%	6.0%	7.0%	6.9%

Source: Bloomberg, PhillipCapital India Research

2. When formal RFPs start in the digital space

While we speak of new-age digital technology cannibalising traditional streams of revenues for Indian IT companies, we have highlighted that the digital space is still in a nascent stage. Indian companies tend to grab market share only when a technology wave reaches maturity. So in order to time the re-entry of our investments into Indian IT companies, we need to time the maturity phase of the digital technology wave.

Just like most technology waves, clients are currently clueless about the scope and possibilities in digital technology. That is why we have consultants like Accenture, Deloitte, and IBM grabbing large share of the market – backed by their consulting division. As a fallout of this nascent digital wave, most engagements in this space today are informal; no formal RFPs are being floated to invite bidders and pursue a competitive bidding process. In most cases, clients enter into engagement agreements with vendors for a year without scope of the problem clearly defined. As the vendor continues to work with the client, the engagement keeps being renewed every year – unless the client is not happy with the vendor.

We believe that WHEN formal RFPs start floating in the digital space – THAT will be the sign of the domain reaching maturity, and THEN Indian IT companies are likely to embark upon a growth trajectory

We believe that WHEN formal RFPs start floating in the digital space – THAT will be the sign of the domain reaching maturity, and THEN Indian IT companies are likely to embark on a growth trajectory. Formal RFPs would mean competitive bidding, where Indian IT companies will be able to bid competitively, backed by their offshoring capabilities. RFPs would also largely reduce the 'incumbent bias' that the client might have for their existing vendors.

3. When growth in digital is able to mitigate decline/deceleration in the traditional segment

We have already established that Indian IT companies are facing deceleration, because the growth in their digital businesses (15-20% of total) is not able to adequately compensate deceleration/decline in their traditional businesses (70-80% of total). As a logical solution to this problem, we deduce that Indian IT companies should start doing well as soon as the growth in their digital businesses is able to adequately compensate the decline in their traditional businesses. However, this is easier stated than tracked.

Crucially, to be able to take advantage of the positive reaction in the stock price, we need to be able to predict this event at least 2-3 quarters BEFORE it happens. We believe the following metrics could help us predict the turnaround moment with reasonable accuracy:

→ When digital segments become big enough to be reported as separate segments – with break up

Currently, most companies report their digital business as one broad number – share of revenues – without divulging any further details, citing the segment is too small to be reported separately. The day most companies (some might start before others) start reporting digital as a separate segment with a breakup of the segment into sub-segments (mobility, analytics and cloud) and start divulging more details about the nature, size, and tenure of the engagements in this space – THAT will be an indicator of the digital business gaining traction and achieving size, so as to be able to mitigate the deceleration/decline in traditional business.

Incremental data that we would like see companies report

Revenue break-up		Deal flow
ADM		**Renewals**
IMS	Reported Now	Traditional
Enterprise		Digital
Digital		Others
Analytics		
Mobility		**New deals**
Cloud		Traditional
Others		Digital
Others		Others

→ When the share of new deals is greater than renewal deals

Currently, renewal deals form more than 60% of the deals won by most IT companies every year. Repeat business constitutes more than 90% of the total business. While these metrics being high reflect clients' confidence in their vendors, it does not capture whether the clients are awarding other outsourcing contracts to other vendors – which is exactly what is happening with Indian IT companies.

Currently, while Indian IT companies continue to win renewal deals, it ends up being more a winner's curse for the following reasons:

1) Most renewals in traditional streams are happening at a 20-30% discount
2) There is very little digital component in these renewals – digital deals are primarily being awarded as new deals, which are not going to incumbents.

1) Most renewals in traditional streams are happening at a 20-30% discount
2) There is very little digital component in these renewals

Hence, a turnaround for the Indian IT companies will happen when the share of new deals (especially in the digital space) starts exceeding share of renewals. With the pace at which renewals are being discounted this should happen soon – but before that, we would need companies to start reporting this break-up, which, unfortunately, none of the companies are doing right now.

Recommendations

Downgrade TCS to SELL – unfavourable risk-reward profile

TCS has the highest exposure to the BFSI segment, which is particularly facing headwinds due to global uncertainties and low-interest-rate regimes. TCS also appears to be quite reluctant to adopt the inorganic route to acquire delivery capabilities in the digital space. While most of its competitors have been acquiring niche companies in the digital space, TCS continues to focus on its in-house capabilities. Currently trading at 15x FY18 P/E, we find valuations expensive and risk-reward profile highly unattractive.

Wipro and MindTree – maintain SELL

We maintain our SELL stance on Wipro and MindTree. While both companies have made decent acquisitions in the digital space to enhance capabilities, we do not find any upside from current levels because of macro uncertainties and lower visibility for FY19 estimates.

Infosys – maintain BUY; on the right track

We maintain BUY on Infosys, as we expect it to regain its industry-leading position as TCS starts decelerating. It is making the right acquisitions and its deal-flow and client metrics have been continuously improving. While there might be quarterly volatility over the course of its journey (due to micro and macro headwinds), we believe the stock will deliver superior returns to long-term investors; accordingly, we lower its multiple to 15x FY18 P/E (from 18x) – but still at a premium to TCS.

Recommendations summary

	CMP	Mkt Cap	Target	PT	Upside	Rating	USD Rev Growth		EBITDA Margins		EPS (Rs)	
	Rs	Rs bn	Multiple	Rs	%		FY17E	FY18E	FY17E	FY18E	FY17E	FY18E
TCS	2,190	4,315	14	2,010	-8%	SELL	6.8	6.9	27.4	26.5	132	140
Infosys	960	2,194	15	1,130	18%	BUY	8.1	9.5	27.0	27.2	63	72
Wipro	457	1,124	11	430	-6%	SELL	4.5	3.6	19.9	19.9	35	38
HCL Tech	793	1,120	13	840	6%	NEUTRAL	11.4	11.0	21.4	21.5	56	63
Tech Mahindra	462	400	11	430	-7%	NEUTRAL	6.0	7.0	15.2	15.7	33	37
MindTree	449	75	12	410	-9%	SELL	10.1	7.6	13.8	14.4	28	32
Persistent	594	48	12	540	-9%	SELL	21.0	8.0	16.0	16.4	39	44
KPIT	132	25	9	120	-9%	SELL	-0.2	5.0	11.6	12.1	12	13
NIIT Tech	420	26	10	500	19%	BUY	1.3	6.9	16.24	16.59	42	48

Financials and valuation snapshot

	$ Revenue Growth			EBITDA Margins			EPS			EPS Growth		
Companies	FY17E	FY18E	FY19E	FY17E	FY18E	FY19E	FY17E	FY18E	FY19E	FY17E	FY18E	FY19E
TCS	6.8	6.9	6.8	27.4	26.5	26.0	132	140	147	7.1	6.4	5.1
Infosys	8.1	9.5	10.0	27.0	27.2	26.9	63	72	78	7.3	13.7	8.7
Wipro	5.7	4.9	5.9	19.9	19.9	20.1	35	38	40	-3.3	8.0	6.9
HCL Tech	11.4	11.0	7.0	21.4	21.5	21.2	56	63	67	9.8	11.6	6.6
Tech Mahindra	6.0	7.0	6.9	15.2	15.7	16.3	33	37	41	-5.7	12.4	12.0
MindTree	10.1	7.6	8.1	13.8	14.4	14.7	28	32	36	-15.8	17.0	9.6
Persistent	21.0	8.0	7.1	16.0	16.4	16.6	39	44	47	5.2	11.4	8.5
KPIT	-0.2	5.0	5.5	11.6	12.1	12.5	12	13	14	-17.8	11.9	10.5
NIIT Tech	1.3	6.9	7.2	16.2	16.6	16.9	42	48	53	-4.6	12.6	11.4

	ROE			PE			PB			EV/EBITDA		
Companies	FY17E	FY18E	FY19E	FY17E	FY18E	FY19E	FY17E	FY18E	FY19E	FY17E	FY18E	FY19E
TCS	29.8	27.2	27.2	16.6	15.6	14.9	5.0	4.2	4.1	12.9	12.1	11.5
Infosys	21.2	21.3	22.9	15.2	13.3	12.3	3.2	2.8	2.8	9.7	8.2	7.6
Wipro	17.1	16.5	15.8	13.1	12.1	11.3	2.2	2.0	1.8	8.8	8.1	7.3
HCL Tech	25.0	25.3	24.1	14.1	12.6	11.9	3.5	3.2	2.9	10.2	8.8	8.2
Tech Mahindra	19.0	18.7	18.2	14.0	12.5	11.1	2.7	2.3	2.0	8.4	7.7	6.7
MindTree	17.4	18.1	17.6	16.2	13.8	12.6	2.8	2.5	2.2	10.1	8.6	7.5
Persistent	16.6	16.3	15.6	15.2	13.6	12.6	2.5	2.2	2.0	10.0	8.8	7.9
KPIT	14.2	13.8	13.2	11.3	10.1	9.1	1.6	1.4	1.2	6.1	5.1	4.1
NIIT Tech	15.1	15.2	16.3	9.9	8.8	7.9	1.5	1.3	1.3	4.2	3.3	2.7

Source: Companies, PhillipCapital India Research

Companies Section

PhillipCapital

Infosys (INFO IN)

Still the fastest-growing large-cap; rerating imminent

INDIA | IT SERVICES | Company Update

6 December 2016

Trading at extremely attractive valuations

Infosys' stock price has corrected 22% over the last six months due to lower-than-expected performance in Q1, consecutive guidance cuts in the last two quarters, and macro uncertainties (Brexit, US elections). It now trades at a highly attractive valuation of 13x FY18 earnings – a discount to TCS' 16x and to its own historical average of 18x. Robust deal wins (US$ 1.2bn in 2QFY17 *highest-ever quarterly number* vs. US$ 2.8bn in FY16) also indicate that it is on the right track to report industry-leading growth over the next few years.

Our analysis of the last 11 years of Infosys' and TCS' valuation histories reveals that Infosys starts trading at a premium to TCS as soon as its growth rate is about to come at par with TCS. Over the last 11 years, TCS has traded at a premium to Infosys in only two prolonged periods (October 2007 to April 2008 and April 2011 - December 2015) – when it delivered much superior results to Infosys. We believe it to be a matter of time before Infosys' discount to TCS changes into a premium.

Guidance cut – as conservative as it can get

Infosys' management lowered its FY17 revenue CC growth guidance in 2QFY17 – to 8.0-9.0% vs. 10.5-12.0% in Q1, 11.5-13.5% in Q4) in CC terms and to 7.5-8.5% in USD terms (from 10.8-12.3% earlier). To achieve the latest guidance, it needs -0.6% to +0.6% CQGR for the remaining two quarters – alluding to the management being extremely conservative. We see the company beating guidance and reporting industry-leading growth in FY17 and beyond.

Vision 2020 – appears to be more a vision, than reality

On joining Infosys, Dr Vishal Sikka had articulated a 2020 vision – US$20bn revenue (US$ 16.5bn from existing services, US$ 2bn from the new services, US$ 1.5bn through acquisitions) with 30% margin and US$ 80,000 revenue per employee. Since then, the company has grown at a modest CQGR of 2%. Uncertainties in the macro environment (Brexit, US elections) and regulatory changes (BFSI, healthcare) resulted in muted growth for all IT companies over the last 2-3 quarters – we expect weakness in the demand environment to continue over next few quarters. Assuming FY17 revenue of US$ 10.2bn (in line with guidance), Infosys would require CAGR of 15% over FY18-21 to achieve its organic revenue target – extremely difficult in our view. However, with automation and operational efficiencies initiatives, it might still achieve its margin and revenue productivity targets.

Strategic acquisitions: In the right direction, making amends to capital allocation policy

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

Elongated path to rerating; downgrade multiple, but maintain BUY

We continue to believe Infosys is on the right track to deliver sustainable superior growth, ahead of peers – with its strong deal-flow, improving client metrics, and focus on automation and 'design-thinking'. While there might be quarterly volatility over the course of its journey due to micro and macro headwinds, we believe the stock will deliver superior returns to long-term investors.

We introduce FY19 estimates and roll forward our valuation to average of FY18-19 earnings. We lower our target multiple to 15x (18x earlier) on macro uncertainties and lower visibility for FY19 estimates. Our new target is Rs 1,130 (Rs 1,270 earlier).

BUY (Maintain)

CMP RS 960

TARGET RS 1130 (+18%)

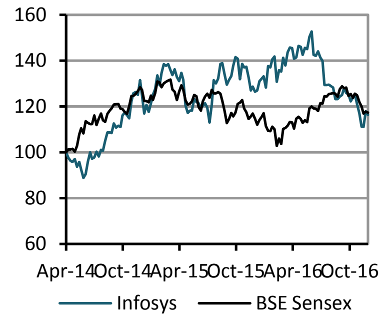
COMPANY DATA

O/S SHARES (MN) :	2297
MARKET CAP (RSBN) :	2208
MARKET CAP (USDBN) :	32.4
52 - WK HI/LO (RS) :	1278 / 900
LIQUIDITY 3M (USDMN) :	53.1
PAR VALUE (RS) :	5

SHARE HOLDING PATTERN, %

	Sep 16	Jun 16	Mar 16
PROMOTERS :	12.8	12.8	12.8
FII / NRI :	39.5	40.5	40.2
FI / MF :	18.0	17.3	17.5
NON PRO :	5.8	5.9	22.3
PUBLIC & OTHERS :	23.9	23.6	7.3

PRICE VS. SENSEX



CHANGE IN ESTIMATES

	Revised Est.		% Revision	
Rs bn	FY17E	FY18E	FY17E	FY18E
Revenue ($mn)	10,274	11,249	0.0%	-0.3%
EBITDA	187	211	0.8%	2.6%
Core PAT	145	165	0.8%	2.4%
EPS (Rs)	63.3	72.0	0.8%	2.4%

KEY FINANCIALS

Rs bn	FY17E	FY18E	FY19E
Net Sales	693.6	776.2	853.5
EBIDTA	187.1	211.3	230.0
Net Profit	144.8	164.6	179.0
EPS, Rs	63.3	72.0	78.3
PER, x	15.2	13.4	12.3
EV/EBIDTA, x	10.0	8.6	7.9
ROE, %	21.2	21.3	22.9

Source: PhillipCapital India Research Est.

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Financials

Income Statement

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Net sales	**624,420**	**693,571**	**776,186**	**853,485**
Growth, %	17.1	11.1	11.9	10.0
Employee expenses	-376,400	-423,937	-472,536	-521,966
Other Operating expenses	-77,230	-82,543	-92,366	-101,565
EBITDA (Core)	**170,790**	**187,091**	**211,284**	**229,954**
Growth, %	14.6	9.5	12.9	8.8
Margin, %	27.4	27.0	27.2	26.9
Depreciation	-14,590	-16,700	-17,594	-18,450
EBIT	**156,200**	**170,392**	**193,690**	**211,504**
Growth, %	12.9	9.1	13.7	9.2
Margin, %	25.0	24.6	25.0	24.8
Forex gains/losses	1,670	159	274	0
Other Non-Operating Income	29,570	32,060	36,250	38,798
Pre-tax profit	**187,440**	**202,610**	**230,214**	**250,301**
Tax provided	-52,520	-57,820	-65,577	-71,302
Profit after tax	**134,920**	**144,790**	**164,637**	**179,000**
Others (Minorities, Associates)	0	0	0	0
Net Profit	**134,920**	**144,790**	**164,637**	**179,000**
Growth, %	9.4	7.3	13.7	8.7
Net Profit (adjusted)	**134,920**	**144,790**	**164,637**	**179,000**
Wtd avg shares (m)	2,286	2,286	2,286	2,286

US$ Revenues

	FY16	FY17E	FY18E	FY19E
US$ Revenue ($ mn)	**9,501**	**10,274**	**11,249**	**12,369**
Growth, %	9.1	8.1	9.5	10.0
Re / US$ (rate)	65.7	67.5	69.0	69.0

Balance Sheet

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Cash & bank	326,970	337,986	391,611	397,286
Marketable securities at cost	0	0	0	0
Debtors	113,300	127,313	142,478	146,051
Inventory	0	0	0	0
Loans & advances	134,420	142,141	161,236	164,175
Total current assets	574,690	607,441	695,325	707,512
Investments	21,050	50,230	60,230	60,230
Net fixed assets	152,790	162,760	171,166	173,130
Non-current assets	0	0	0	0
Total assets	**753,890**	**826,711**	**933,001**	**947,152**
Total current liabilities	136,100	144,312	160,958	164,920
Non-current liabilities	0	0	0	0
Total liabilities	136,100	144,312	160,958	164,920
Paid-up capital	11,440	11,440	11,440	11,440
Reserves & surplus	606,350	670,959	760,603	770,791
Minorities	0	0	0	0
Shareholders' equity	617,790	682,399	772,043	782,231
Total equity & liabilities	**753,890**	**826,711**	**933,001**	**947,152**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Pre-tax profit	187,440	202,610	230,214	250,301
Depreciation	14,590	16,700	17,594	18,450
Chg in working capital	-25,700	-13,522	-17,613	-2,549
Total tax paid	-52,510	-58,740	-65,577	-71,302
Other operating activities	0	0	0	0
Cash flow from operating activities	**123,820**	**147,047**	**164,618**	**194,901**
Capital expenditure	-38,840	-26,670	-26,000	-20,415
Chg in investments	3,080	-29,180	-10,000	0
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-35,760**	**-55,850**	**-36,000**	**-20,415**
Free cash flow	88,060	91,197	128,618	174,486
Equity raised/(repaid)	5,720	0	0	0
Debt raised/(repaid)	0	0	0	0
Dividend (incl. tax)	-64,846	-69,525	-74,873	-74,873
Other financing activities	-5,634	-10,655	-120	-93,938
Cash flow from financing activities	**-64,760**	**-80,181**	**-74,993**	**-168,811**
Net chg in cash	23,300	11,016	53,625	5,675

Valuation Ratios

	FY16	FY17E	FY18E	FY19E
Per Share data				
EPS (INR)	53.9	59.0	63.3	72.0
Growth, %	15.8	9.4	7.3	13.7
Book NAV/share (INR)	239.6	270.3	298.6	337.8
CFPS (INR)	28.3	41.2	50.3	56.2
DPS (INR)	59.9	24.2	26.0	28.0
Return ratios				
Return on assets (%)	20.0	19.0	18.3	18.7
Return on equity (%)	22.5	21.8	21.2	21.3
Return on capital employed (%)	24.0	23.0	22.2	22.6
Turnover ratios				
Asset turnover (x)	2.9	2.6	2.5	2.6
Sales/Total assets (x)	0.9	0.9	0.9	0.9
Sales/Net FA (x)	4.6	4.4	4.4	4.6
Working capital/Sales (x)	0.2	0.2	0.2	0.2
Receivable days	66.5	66.2	67.0	67.0
Liquidity ratios				
Current ratio (x)	4.5	4.4	4.2	4.3
Quick ratio (x)	4.5	4.4	4.2	4.3
Dividend cover (x)	0.9	2.4	2.4	2.6
Net debt/Equity (%)	(59.9)	(56.3)	(56.9)	(58.5)
Valuation				
PER (x)	17.9	16.3	15.2	13.4
PEG (x) - y-o-y growth	1.1	1.7	2.1	1.0
Price/Book (x)	4.0	3.6	3.2	2.9
Yield (%)	6.2	2.5	2.7	2.9
EV/Net sales (x)	3.6	3.0	2.7	2.3
EV/EBITDA (x)	12.8	11.0	10.0	8.6
EV/EBIT (x)	13.8	12.0	11.0	9.4

INSTITUTIONAL EQUITY RESEARCH

PhillipCapital

Tata Consultancy Services (TCS IN)

Losing momentum; risk reward unattractive

INDIA | IT SERVICES | Company Update

6 December 2016

Not much that the company can surprise positively, from current levels

TCS has had a topsy-turvy FY17 so far. It reported a strong set of numbers in 1QFY17, leading to the stock rising to Rs 2700. However, profit warning and poor show in 2QFY17 led to a significant correction, exacerbated by US election results. However, YTD, the stock has outperformed all other large-cap IT services companies and is currently trading at 16x FY18 P/E – a significant premium to Infosys' 13x. With the company expected to report USD revenue growth of 7-8% in FY17 – below Infosys and Nasscom guidance – we do not foresee any positive surprise that the company could deliver. We find the risk-reward profile highly unattractive at current levels.

Large base and high expectations – finally catching up

TCS is now a giant in size. Its FY17E topline of US$ 18bn is in catching distance of Fortune-500 companies. For the company to grow in double-digits on this base, implies adding US$ 2bn revenues annually (incremental revenues of only US$ 1.1bn in the last four quarters) – a herculean task for any company! We believe the last six quarters of below-expectations growth (except 1QFY17) are a clear indication that its growth engine is slowing down. In FY16, it missed consensus topline growth estimates for four consecutive quarters, leading to muted stock performance. In FY17, it is likely to report revenue growth at the bottom end of Nasscom's guidance.

High exposure to BFSI and UK turning out to be an Achilles' heel

TCS has the highest exposure to the BFSI segment (40% of revenue vs. 25-35% for Infosys, Wipro, and HCL). The BFSI segment, particularly, is facing headwinds due to global uncertainties (Brexit, US elections) and low interest rate regimes. At the same time, disruptions like analytics, mobility, and blockchain are forcing global BFS enterprises to shift spending away from traditional service lines. TCS' exposure to the UK (15% of revenues vs. less than 10% for all others except TechM) is also likely to keep growth muted due to impending uncertainties in the business environment following Brexit.

Lack of acquisitions hurting growth and perception

TCS appears to be quite reluctant to adopt the inorganic route to acquire delivery capabilities in the digital space (read our detailed report here, in which we highlighted this as the main rationale for downgrading the sector). While most of its competitors – Cognizant, Infosys, Wipro, HCL Tech, TechM, and MindTree – have been acquiring niche companies in the digital space, TCS continues to focus on its in-house capabilities, which we believe will be difficult to market due to the global 'perception' of Indian IT companies.

Valuations to de-rate and come at par with Infosys

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

Outlook and Valuation

Currently trading at 16x FY18 P/E, we find valuations expensive for the company and risk-reward profile highly unattractive. We introduce FY19 estimates and roll forward our valuation to the average of FY18-19 earnings. We lower our target multiple to 14x (17x earlier) – a 5% discount to Infosys – on macro uncertainties and lower visibility for FY19 estimates. Our target is Rs 2,040 (Rs 2,400 earlier). We downgrade to SELL.

SELL (Downgrade)

CMP RS 2190

TARGET RS 2010 (-8%)

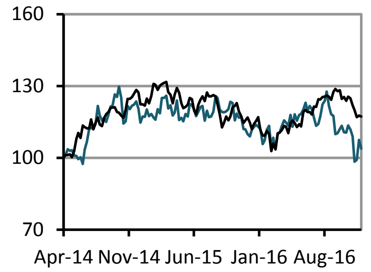
COMPANY DATA

O/S SHARES (MN) :	1970
MARKET CAP (RSBN) :	4308
MARKET CAP (USDBN) :	63.1
52 - WK HI/LO (RS) :	2740 / 2055
LIQUIDITY 3M (USDMN) :	47.0
PAR VALUE (RS) :	1

SHARE HOLDING PATTERN, %

	Sep 16	Jun 16	Mar 16
PROMOTERS :	73.3	73.3	73.4
FII / NRI :	17.1	17.0	16.9
FI / MF :	5.1	5.1	5.1
NON PRO :	0.9	0.9	0.9
PUBLIC & OTHERS :	3.6	3.6	3.7

PRICE VS. SENSEX



CHANGE IN ESTIMATES

	Revised Est.		% Revision	
Rs bn	FY17E	FY18E	FY17E	FY18E
Revenue($ mn)	17,662	18,887	-0.4%	-1.5%
EBITDA	1,192.9	1,303.2	0.4%	1.4%
Core PAT	327.1	345.5	0.8%	0.5%
EPS (Rs)	259.3	276.1	0.4%	0.2%

KEY FINANCIALS

Rs bn	FY17E	FY18E	FY19E
Net Sales	1,192.9	1,303.2	1,391.8
EBIDTA	327.1	345.5	362.2
Net Profit	259.3	276.1	290.1
EPS, Rs	131.6	140.1	147.3
PER, x	16.9	15.8	15.1
EV/EBIDTA, x	13.1	12.3	11.7
P/BV, x	5.0	4.3	4.1
ROE, %	29.8	27.2	27.2

Source: PhillipCapital India Research Est.

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Financials

Income Statement

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Net sales	**10,86,462**	**11,92,868**	**13,03,235**	**13,91,775**
Growth, %	14.8	9.8	9.3	6.8
Employee expenses	-5,95,489	-6,58,837	-7,32,617	-7,93,920
Other Operating expenses	-1,84,193	-2,06,958	-2,25,148	-2,35,665
EBITDA (Core)	**3,06,780**	**3,27,072**	**3,45,471**	**3,62,190**
Growth, %	24.4	6.6	5.6	4.8
Margin, %	28.2	27.4	26.5	26.0
Depreciation	-18,879	-20,385	-22,767	-24,807
EBIT	**2,87,901**	**3,06,688**	**3,22,703**	**3,37,383**
Growth, %	26.3	6.5	5.2	4.5
Margin, %	26.5	25.7	24.8	24.2
Interest paid	0	0	0	0
Other Non-Operating Income	30,503	37,016	39,086	41,900
Pre-tax profit	**3,18,404**	**3,40,116**	**3,60,851**	**3,79,275**
Tax provided	-75,027	-80,607	-84,800	-89,130
Profit after tax	**2,43,377**	**2,59,510**	**2,76,051**	**2,90,146**
Others (Minorities, Associates)	-1,229	-180	0	0
Net Profit	**2,42,148**	**2,59,330**	**2,76,051**	**2,90,146**
Growth, %	23.2	7.1	6.4	5.1
Net Profit (adjusted)	**2,42,148**	**2,59,330**	**2,76,051**	**2,90,146**
Wtd avg shares (m)	1,970	1,970	1,970	1,970

US$ Revenues

	FY16	FY17E	FY18E	FY19E
US$ Revenue ($ mn)	**16,544**	**17,662**	**18,887**	**20,171**
Growth, %	7.1	6.8	6.9	6.8
Re / US$ (rate)	65.7	67.5	69.0	69.0

Balance Sheet

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Cash & bank	62,950	91,310	1,22,482	1,44,468
Marketable securities at cost	0	0	0	0
Debtors	2,40,730	2,65,548	2,88,247	2,93,119
Inventory	0	0	0	0
Other current assets	1,03,660	1,24,371	1,35,002	1,37,283
Total current assets	4,07,340	4,81,229	5,45,731	5,74,870
Investments	2,28,220	2,88,220	3,48,220	3,63,220
Net fixed assets	2,76,560	2,99,957	3,42,593	3,53,135
Non-current assets	0	0	0	0
Total assets	**9,12,120**	**10,69,407**	**12,36,544**	**12,91,224**
Total current liabilities	1,55,690	1,71,273	1,89,501	1,95,048
Non-current liabilities	21,000	24,555	26,600	27,038
Total liabilities	1,76,690	1,95,828	2,16,101	2,22,087
Paid-up capital	1,970	1,970	1,970	1,970
Reserves & surplus	7,29,920	8,67,888	10,14,753	10,63,447
Minorities	3,540	3,720	3,720	3,720
Shareholders' equity	7,35,430	8,73,578	10,20,443	10,69,137
Total equity & liabilities	**9,12,120**	**10,69,407**	**12,36,544**	**12,91,224**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Pre-tax profit	3,18,404	3,40,116	3,60,851	3,79,275
Depreciation	18,879	20,385	22,767	24,807
Chg in working capital	1,21,027	-26,191	-13,057	-1,167
Total tax paid	-75,027	-80,607	-84,800	-89,130
Other operating activities	0	0	0	0
Cash flow from operating activities	**3,83,283**	**2,53,703**	**2,85,762**	**3,13,786**
Capital expenditure	-36,115	-43,782	-65,404	-35,348
Chg in investments	-2,10,677	-60,000	-60,000	-15,000
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-2,46,792**	**-1,03,782**	**-1,25,404**	**-50,348**
Free cash flow	1,36,491	1,49,921	1,60,358	2,63,438
Equity raised/(repaid)	11	0	0	0
Debt raised/(repaid)	-313	-200	0	0
Dividend (incl. tax)	-1,00,168	-1,21,361	-1,29,186	-1,35,782
Other financing activities	15,131	0	0	-1,05,669
Cash flow from financing activities	**-92,162**	**-1,21,561**	**-1,29,186**	**-2,41,452**
Net chg in cash	44,328	28,360	31,172	21,986

Valuation Ratios

	FY16	FY17E	FY18E	FY19E
Per Share data				
EPS (INR)	122.9	131.6	140.1	147.3
Growth, %	22.5	7.1	6.4	5.1
Book NAV/share (INR)	371.4	441.5	516.0	540.7
CFPS (INR)	179.0	110.0	125.2	138.0
DPS (INR)	43.5	52.6	56.0	58.9
Return ratios				
Return on assets (%)	29.3	26.2	23.9	23.0
Return on equity (%)	33.1	29.8	27.2	27.2
Return on capital employed (%)	35.8	31.4	28.4	27.1
Turnover ratios				
Asset turnover (x)	2.2	2.5	2.5	2.5
Sales/Total assets (x)	1.3	1.2	1.1	1.1
Sales/Net FA (x)	4.1	4.1	4.1	4.0
Working capital/Sales (x)	0.2	0.2	0.2	0.2
Receivable days	80.9	81.3	80.7	76.9
Liquidity ratios				
Current ratio (x)	2.6	2.8	2.9	2.9
Quick ratio (x)	2.6	2.8	2.9	2.9
Dividend cover (x)	2.8	2.5	2.5	2.5
Total debt/Equity (%)	0.1	0.1	0.1	0.1
Net debt/Equity (%)	(8.5)	(10.4)	(12.0)	(13.5)
Valuation				
PER (x)	18.1	16.9	15.8	15.1
PEG (x) - y-o-y growth	0.8	2.4	2.5	3.0
Price/Book (x)	6.0	5.0	4.3	4.1
Yield (%)	2.0	2.4	2.5	2.7
EV/Net sales (x)	4.0	3.6	3.3	3.0
EV/EBITDA (x)	14.1	13.1	12.3	11.7
EV/EBIT (x)	15.0	14.0	13.2	12.5

HCL Technologies (HCLT IN)

On the right track; but valuations to be capped

INDIA | IT SERVICES | Company Update

6 December 2016

On the right track, but major concerns still remain

After reporting decent results in 1HFY17, HCL Tech guided for CC USD revenue growth of 11.0-13.0% in FY17 – of which ~8.0-8.5% would be organic – the highest among its large-cap peers (ex-Infosys). Simultaneously, it has managed to maintain its margins and announced multiple IP deals and acquisitions. It appears to be on the right track to enhance its revenue profile. However, with an inferior digital portfolio and higher share of IMS (which is under threat from cloud adoption), we see a cap on valuations and limited upside potential from current levels.

Deceleration in the erstwhile growth driver; IMS remains a BIG concern

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

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

ERD division going strong, but can only do so much

HCL is the largest Indian IT services player in the ERD domain, with revenues of US$ 1.2bn in FY16. It is also the third-largest ESO company in the world, second to Altran Technologies and Alten SA – both French companies. We are highly optimistic about the potential of the ERD domain, where Indian IT companies are looking to increase their presence based on domain expertise developed over the last decade and abundant supply of engineers. HCL strengthened its presence in this domain when it acquired Geometric Ltd (a provider of engineering services and PLM solutions, US$ 203mn revenues) in April 2016 and Butler America Aerospace Ltd (a US-based ERD company, US$ 85mn revenues) in October 2016. While we expect ERD to report strong growth for HCLT, at 18% of the company's total revenue base, it will not be able to mitigate the impact of deceleration/decline in the remaining traditional business.

Making amends to the inefficient capital allocation policy

Over the last 10 years, HCL generated Rs 269bn of OCF and paid out 34% of this cash as dividends and 36% is sitting as cash/investments. It did not acquire any company of significant size/capability apart from Axon in 2008. However, over the last six months it made six acquisitions, adding ~US$ 500mn to its revenues. Though four of those acquisitions were in the traditional IT domains (like ADM, IMS), the last two (Geometric, Butler) in ERD indicate that it is finally making amends to its capital-allocation policy and looking to invest in new-age digital-technology companies.

Currently, the stock is trading at 13x FY18 P/E. We introduce FY19 estimates and roll forward our valuation to average of FY18-19 earnings. We lower our target multiple to 13x (14x earlier) – at a premium to Wipro and TechM. Our target is Rs 840 (Rs 870 earlier). Maintain NEUTRAL.

NEUTRAL (Maintain)

CMP RS 793

TARGET RS 840 (+6%)

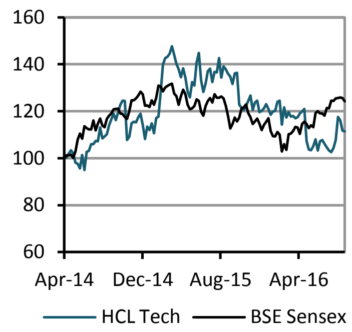
COMPANY DATA

O/S SHARES (MN) :	1411
MARKET CAP (RSBN) :	1118
MARKET CAP (USDBN) :	16.4
52 - WK HI/LO (RS) :	890 / 707
LIQUIDITY 3M (USDMN) :	21.8
PAR VALUE (RS) :	2

SHARE HOLDING PATTERN, %

	Sep 16	Jun 16	Mar 16
PROMOTERS :	60.4	60.4	60.4
FII / NRI :	25.7	25.7	26.9
FI / MF :	6.7	6.6	5.7
NON PRO :	1.2	1.2	4.3
PUBLIC & OTHERS :	6.0	6.2	2.7

PRICE VS. SENSEX



CHANGE IN ESTIMATES

	Revised Est.		% Revision	
Rs bn	FY17E	FY18E	FY17E	FY18E
Revenue($ mn)	6,944	7,709	0.0%	1.9%
EBITDA	100.5	114.2	0.9%	4.6%
Core PAT	79.4	89.6	0.2%	3.1%
EPS (Rs)	56.2	62.7	0.2%	2.1%

KEY FINANCIALS

Rs mn	FY17E	FY18E	FY19E
Net Sales	468.7	531.9	569.3
EBIDTA	100.5	114.2	120.8
Net Profit	79.4	89.6	95.5
EPS, Rs	56.2	62.7	66.9
PER, x	14.1	12.6	11.8
EV/EBIDTA, x	9.9	8.7	8.0
P/BV, x	3.5	3.2	2.8
ROE, %	25.0	25.3	24.1

Source: PhillipCapital India Research Est.

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Financials

Income Statement

Y/E Mar, Rs mn	FY16*	FY17E	FY18E	FY19E
Net sales	**311,360**	**468,684**	**531,915**	**569,277**
Growth, %	-16	51	13	7
Employee expenses	-204,710	-311,100	-358,440	-385,468
Other Operating expenses	-39,690	-57,121	-59,262	-62,972
EBITDA (Core)	**66,960**	**100,462**	**114,213**	**120,838**
Growth, %	(23.1)	50.0	13.7	5.8
Margin, %	21.5	21.4	21.5	21.2
Depreciation	-4,450	-7,767	-8,613	-9,146
EBIT	**62,510**	**92,696**	**105,600**	**111,691**
Growth, %	(24.2)	48.3	13.9	5.8
Margin, %	20.1	19.8	19.9	19.6
Other Non-Operating Income	6,630	7,983	9,153	9,977
Forex Gains\ (Losses)	370	216	-644	0
Pre-tax profit	**69,510**	**100,894**	**114,109**	**121,668**
Tax provided	-14,990	-21,453	-24,534	-26,159
Profit after tax	**54,520**	**79,441**	**89,576**	**95,509**
Non Recurring Item	0	0	0	0
Net Profit	**54,520**	**79,441**	**89,576**	**95,509**
Growth, %	(24.9)	45.7	12.8	6.6
Net Profit (adjusted)	**54,520**	**79,441**	**89,576**	**95,509**
Wtd avg shares (m)	1,412	1,413	1,428	1,428

US$ Revenues

	FY16	FY17E	FY18E	FY19E
US$ Revenue ($ mn)	**6,236**	**6,944**	**7,709**	**8,250**
Growth, %	7.1	11.4	11.0	7.0
Re / US$ (rate)	66.3	67.5	69.0	69.0

Balance Sheet

Y/E Mar, Rs mn	FY16*	FY17E	FY18E	FY19E
Cash & bank	7,293	23,339	28,080	54,108
Marketable securities at cost	111,236	120,351	130,351	140,351
Debtors	107,228	111,714	126,785	135,691
Inventory	0	0	0	0
Other current assets	24,102	26,663	30,395	31,974
Total current assets	249,859	282,067	315,612	362,123
Investments	1,601	1,452	1,452	1,452
Net fixed assets	146,213	178,356	201,742	208,835
Non-current assets	0	0	0	0
Total assets	**397,673**	**461,875**	**518,805**	**572,410**
Total current liabilities	95,085	119,326	137,484	147,851
Non-current liabilities	22,367	24,154	26,699	27,775
Total liabilities	117,452	143,480	164,183	175,626
Paid-up capital	1,413	1,413	1,428	1,428
Reserves & surplus	278,808	316,982	353,195	395,356
Minorities	0	0	0	0
Shareholders' equity	280,221	318,395	354,623	396,784
Total equity & liabilities	**397,673**	**461,875**	**518,805**	**572,410**

Source: Company, PhillipCapital India Research Estimates

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

Cash Flow

Y/E Mar, Rs mn	FY16*	FY17E	FY18E	FY19E
Pre-tax profit	69,510	100,894	114,109	121,668
Depreciation	4,450	7,767	8,613	9,146
Chg in working capital	-10,325	17,194	-646	-117
Total tax paid	-14,990	-21,453	-24,534	-26,159
Other operating activities	0	0	0	0
Cash flow from operating activities	**48,645**	**104,402**	**97,543**	**104,539**
Capital expenditure	-29,763	-39,910	-31,998	-16,240
Chg in investments	-1,521	149	0	0
Chg in marketable securities	-6,866	-9,115	-10,000	-10,000
Other investing activities	0	0	0	0
Cash flow from investing activities	**-38,150**	**-48,876**	**-41,998**	**-26,240**
Free cash flow	10,495	55,526	55,545	78,299
Equity raised/(repaid)	0	0	15	0
Debt raised/(repaid)	5,087	1,787	2,545	1,076
Dividend (incl. tax)	-29,648	-39,586	-53,348	-53,348
Other financing activities	7,839	-1,681	-15	0
Cash flow from financing activities	**-16,722**	**-39,480**	**-50,803**	**-52,272**
Net chg in cash	-6,227	16,046	4,741	26,027

Valuation Ratios

	FY16*	FY17E	FY18E	FY19E
Per Share data				
EPS (INR)	38.6	56.2	62.7	66.9
Growth, %	(24.9)	45.7	11.6	6.6
Book NAV/share (INR)	198.4	225.3	248.3	277.9
CFPS (INR)	29.7	68.2	61.9	66.2
DPS (INR)	17.9	23.9	31.9	31.9
Return ratios				
Return on assets (%)	14.4	18.5	18.3	17.5
Return on equity (%)	19.5	25.0	25.3	24.1
Return on capital employed (%)	19.2	24.6	24.7	23.7
Turnover ratios				
Asset turnover (x)	1.9	2.5	2.5	2.5
Sales/Total assets (x)	0.8	1.1	1.1	1.0
Sales/Net FA (x)	2.3	2.9	2.8	2.8
Working capital/Sales (x)	0.1	0.0	0.0	0.0
Receivable days	125.7	87.0	87.0	87.0
Liquidity ratios				
Current ratio (x)	2.6	2.4	2.3	2.4
Quick ratio (x)	2.6	2.4	2.3	2.4
Dividend cover (x)	2.2	2.3	2.0	2.1
Total debt/Equity (%)	8.0	7.6	7.5	7.0
Net debt/Equity (%)	5.4	0.3	(0.4)	(6.6)
Valuation				
PER (x)	20.5	14.1	12.6	11.8
PEG (x) - y-o-y growth	(0.8)	0.3	1.1	1.8
Price/Book (x)	4.0	3.5	3.2	2.8
Yield (%)	2.3	3.0	4.0	4.0
EV/Net sales (x)	3.3	2.1	1.9	1.7
EV/EBITDA (x)	15.2	9.9	8.7	8.0
EV/EBIT (x)	16.3	10.8	9.4	8.6

INSTITUTIONAL EQUITY RESEARCH

Wipro (WPRO IN)

Miles to go before …

INDIA | IT SERVICES | Company Update

6 December 2016

Continues to disappoint on growth

Consistent with Wipro's last seven quarters of results, its 3QFY17 guidance did not allay growth concerns. Wipro's revenue growth was below industry average and peers in FY16, and we continue to expect sub-5% USD organic growth for its IT-services business in FY17 – the lowest in our large-cap coverage universe. We also do not see the scenario changing much over the next 2-3 years and see Wipro lagging its peers.

Over the last nine quarters, Wipro has consistently disappointed in terms of its growth rate. While it reported below-industry average growth over FY12-14 too, a large part of it was due to the management reshuffle. Strong deal-wins in FY15 of US$ 3bn vs. US$ 1.55bn in FY14 (*announced large deals*) led to the belief that it was finally turning the corner. However, it reported revenue growth of 7.0%/3.7% in FY15/16 despite robust deal flow, as it continued to lose a large part of its existing business to competitors.

Another round of management reshuffle will further delay revival

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

Retracing its 'string of pearls' strategy – but a bit too late maybe

Over the last few months, Wipro has made five acquisitions at a total investment of US$ 1.1bn; these added US$ 510mn to its topline. It clearly seems to be retracing its 'string of pearls' strategy of early 2000, where it had embarked upon a series of acquisitions to drive growth. While the initial few acquisitions were in the traditional technology spaces of IMS/BPO/ADM, the more recent ones like Appirio are in the new-age digital space. We view this development as a positive step by the company, and see it benefitting in the long run. However, the move has probably come a bit too late (for other Indian IT companies as well) to mitigate near-term headwinds.

Captures the early-mover advantage, but squanders it away

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

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

Currently, Wipro trades at 12x FY18 P/E – at a discount to its large-cap peers (ex TechM). We introduce FY19 estimates and roll forward our valuation to average of FY18-19 earnings. We lower our target multiple to 11x (12x earlier) – at par with TechM – based on macro uncertainties and lower visibility for FY19 estimates. Our target is Rs 430 (Rs 470 earlier). We maintain SELL.

SELL (Maintain)

CMP RS 457

TARGET RS 430 (-6%)

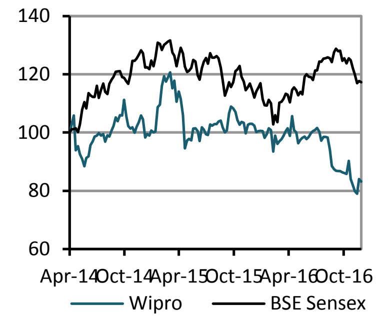
COMPANY DATA

O/S SHARES (MN) :	2431
MARKET CAP (RSBN) :	1110
MARKET CAP (USDBN) :	16.3
52 - WK HI/LO (RS) :	607 / 410
LIQUIDITY 3M (USDMN) :	12.9
PAR VALUE (RS) :	2

SHARE HOLDING PATTERN, %

	Sep 16	Jun 16	Mar 16
PROMOTERS :	73.3	55.5	73.3
FII / NRI :	11.3	7.0	11.6
FI / MF :	5.0	4.2	4.6
NON PRO :	3.9	29.1	3.9
PUBLIC & OTHERS :	6.6	4.1	6.6

PRICE VS. SENSEX



CHANGE IN ESTIMATES

	Revised Est.		% Revision	
Rs bn	FY17E	FY18E	FY17E	FY18E
Revenue($ mn)	8,155	8,449	-1.6%	-4.2%
EBITDA	110.2	116.0	0.2%	-4.0%
Core PAT	85.2	91.7	0.1%	-4.2%
EPS (Rs)	35.0	37.8	0.1%	-4.2%

KEY FINANCIALS

Rs bn	FY17E	FY18E	FY19E
Net Sales	552.8	583.0	613.2
EBIDTA	110.2	116.0	123.4
Net Profit	85.2	91.7	98.0
EPS, Rs	35.0	37.8	40.4
PER, x	13.1	12.1	11.3
EV/EBIDTA, x	8.5	7.6	6.7
P/BV, x	2.2	2.0	1.8
ROE, %	17.1	16.5	15.8

Source: PhillipCapital India Research Est.

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Financials

Income Statement

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Net sales	**512,440**	**552,771**	**582,960**	**613,204**
Growth, %	9.1	7.9	5.5	5.2
Employee expenses	-341,759	-371,998	-393,852	-413,450
Other Operating expenses	-58,775	-70,536	-73,127	-76,330
EBITDA (Core)	**111,906**	**110,237**	**115,981**	**123,424**
Growth, %	3.4	(1.5)	5.2	6.4
Margin, %	21.8	19.9	19.9	20.1
Depreciation	-14,965	-18,824	-19,047	-19,573
EBIT	**96,941**	**91,413**	**96,934**	**103,851**
Growth, %	1.6	(5.7)	6.0	7.1
Margin, %	18.9	16.5	16.6	16.9
Interest paid	0	0	0	0
Other Non-Operating Income	17,915	18,544	21,014	22,227
Pre-tax profit	**114,856**	**109,957**	**117,947**	**126,078**
Tax provided	-25,326	-24,483	-25,948	-27,737
Profit after tax	**89,530**	**85,475**	**91,999**	**98,341**
Others (Minorities, Associates)	-492	-281	-297	-318
Net Profit	**89,038**	**85,194**	**91,702**	**98,023**
Growth, %	2.9	(4.3)	7.6	6.9
Net Profit (adjusted)	**89,038**	**85,194**	**91,702**	**98,023**
Wtd avg shares (m)	2,461	2,435	2,427	2,427

US$ Revenues

	FY16	FY17E	FY18E	FY19E
US$ Revenue ($ mn)	**7,346**	**7,765**	**8,143**	**8,628**
Growth, %	3.7	5.7	4.9	5.9
Re / US$ (rate)	66.3	68.1	69.0	69.0

Balance Sheet

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Cash & bank	99,049	67,306	115,238	167,192
Marketable securities at cost	204,244	258,499	258,499	258,499
Debtors	100,976	103,836	109,507	115,188
Inventory	5,390	6,772	7,141	7,512
Other current assets	94,528	98,338	103,709	109,089
Total current assets	504,187	534,751	594,094	657,480
Investments	0	0	0	0
Net fixed assets	182,784	188,386	193,839	198,766
Non-current assets	37,032	33,193	35,006	36,822
Total assets	**724,003**	**756,330**	**822,939**	**893,069**
Total current liabilities	218,561	218,205	223,868	229,029
Non-current liabilities	38,058	38,084	39,218	40,252
Total liabilities	256,619	256,289	263,086	269,282
Paid-up capital	4,941	4,861	4,861	4,861
Reserves & surplus	460,219	492,675	552,189	615,806
Minorities	2,224	2,506	2,803	3,121
Shareholders' equity	467,384	500,041	559,853	623,787
Total equity & liabilities	**724,003**	**756,330**	**822,939**	**893,069**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Pre-tax profit	114,856	109,957	117,947	126,078
Depreciation	14,965	18,824	19,047	19,573
Chg in working capital	73,576	-4,569	-7,561	-8,087
Total tax paid	-25,326	-24,483	-25,948	-27,737
Other operating activities	0	0	0	0
Cash flow from operating activities	**178,071**	**99,729**	**103,485**	**109,827**
Capital expenditure	-67,534	-24,426	-24,500	-24,500
Chg in investments	0	0	0	0
Chg in marketable securities	-150,336	-54,255	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-217,870**	**-78,681**	**-24,500**	**-24,500**
Free cash flow	-39,799	21,048	78,985	85,327
Equity raised/(repaid)	4,320	-9,652	0	0
Debt raised/(repaid)	11,682	26	1,134	1,034
Dividend (incl. tax)	-17,273	-29,795	-32,187	-34,406
Other financing activities	-18,907	-13,371	0	0
Cash flow from financing activities	**-20,092**	**-52,791**	**-31,053**	**-33,372**
Net chg in cash	-59,891	-31,743	47,932	51,954

Valuation Ratios

	FY16	FY17E	FY18E	FY19E
Per Share data				
EPS (INR)	36.2	35.0	37.8	40.4
Growth, %	3.1	(3.3)	8.0	6.9
Book NAV/share (INR)	189.0	204.3	229.5	255.8
CFPS (INR)	49.7	32.3	34.7	36.8
DPS (INR)	6.0	10.5	11.3	12.1
Return ratios				
Return on assets (%)	13.5	11.5	11.7	11.5
Return on equity (%)	19.1	17.1	16.5	15.8
Return on capital employed (%)	19.0	16.4	16.2	15.6
Turnover ratios				
Asset turnover (x)	1.9	2.0	2.0	2.0
Sales/Total assets (x)	0.8	0.7	0.7	0.7
Sales/Net FA (x)	3.3	3.0	3.1	3.1
Receivable days	71.9	68.6	68.6	68.6
Inventory days	3.8	4.5	4.5	4.5
Liquidity ratios				
Current ratio (x)	2.3	2.5	2.7	2.9
Quick ratio (x)	2.3	2.4	2.6	2.8
Dividend cover (x)	6.0	3.3	3.3	3.3
Total debt/Equity (%)	31.4	29.1	26.2	23.7
Net debt/Equity (%)	10.1	15.6	5.5	(3.3)
Valuation				
PER (x)	12.7	13.1	12.1	11.3
PEG (x) - y-o-y growth	4.0	(3.9)	1.5	1.6
Price/Book (x)	2.4	2.2	2.0	1.8
Yield (%)	1.3	2.3	2.5	2.6
EV/Net sales (x)	1.9	1.7	1.5	1.4
EV/EBITDA (x)	8.7	8.5	7.6	6.7
EV/EBIT (x)	10.0	10.2	9.1	8.0

Tech Mahindra (TECHM IN)

Business mix to keep growth and valuations depressed

INDIA | IT SERVICES | Company Update

6 December 2016

Consensus expectation have been cut, but still too optimistic

TechM's stock has corrected 10% in the last six months, despite the recent run-up (+15%, 1m) mainly due to its sub-par financial performance in recent quarters. At current levels, it trades at 12x FY18 P/E 'consensus' earnings, which have already shrunk 6% as the company continued to disappoint and paint a rather gloomy picture of the demand environment. However, FY18 consensus estimates point to 10% revenue growth – despite only 6% in FY17E. We find consensus numbers aggressive and see them being lowered in coming quarters – just like FY18 estimates were cut over the last two quarters – leading to incremental pressure on its stock price.

Telecom business – Too big to grow

We believe the telecom vertical has now become too big for TechM to be able to grow in double digits. The business, now at over US$ 2bn in annual revenues, has reported a CAGR of 14% over the last five years and accounts for 34% of the total telecom revenue of the top-5 Indian IT companies. However, over the last few quarters, even after adjusting for LCC, we have seen a clear deceleration in TechM's telecom business – CQGR of -1% over the last four quarters versus 3% over the preceding four. Even in FY16, the segment reported organic USD revenue growth of only 1.5%, largely due to a decline in top 1/5/10 clients. With leading global telecom giants like AT&T, Verizon, and BT already under its belt, a deceleration/decline in TechM's telecom revenues is imminent.

Skewed business mix to keep growth under check

While TechM's enterprise business has been growing strongly, telecom continues to remain weak. Its woes in the telecom sector appear to have bottomed out, but the sector is far from being close to witnessing a secular revival in spending. With telecom forming ~50% of its business, TechM's growth will always lag industry and peers unless the segment sees significant momentum. Its enterprise business will, at best, grow at industry average. **This combination – of half of its business (enterprise) growing at and the other half (telecom) below industry average – will always keep TechM's growth lower than its peers.**

No clarity on margin revival; expect LCC pain to continue

TechM's management has not been able to provide any timeline for the revival of LCC and TechM's margins. After the LCC acquisition, margins fell by 530bps to 14.9% (from 20.2%). Though the company delivered strong margin performance in Q2FY17, margins are expected to remain under pressure due to multiple headwinds (like GBP volatility, acquisitions, salary hike, visa cost, etc.).

Outlook and valuation

TechM delivered strong performance in Q2FY17, but the persisting weakness in its telecom domain and impending macro uncertainties (Brexit, US elections) make us maintain our negative stance and believe that the stock will remain under pressure. At current levels, we do not see any upside. However, with valuations at 12xFY18 P/E, we do not see material downside either.

We introduce FY19 estimates and roll forward our valuation to average of FY18-19 earnings. We lower our target multiple to 11x (12x earlier) – at par with Wipro – on macro uncertainties and lower visibility of FY19 estimates. Our target is Rs 430 (Rs 420 earlier). We maintain NEUTRAL.

NEUTRAL (Maintain)

CMP RS 462

TARGET RS 430 (-7%)

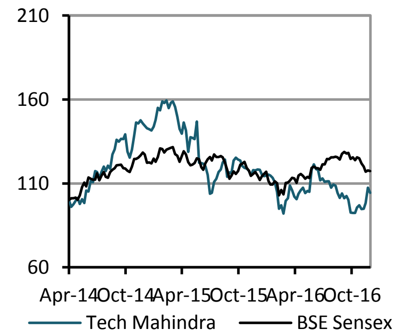
COMPANY DATA

O/S SHARES (MN) :	971
MARKET CAP (RSBN) :	449
MARKET CAP (USDBN) :	6.6
52 - WK HI/LO (RS) :	557 / 403
LIQUIDITY 3M (USDMN) :	22.1
PAR VALUE (RS) :	5

SHARE HOLDING PATTERN, %

	Sep 16	Jun 16	Mar 16
PROMOTERS :	36.3	36.3	36.4
FII / NRI :	39.4	39.6	38.1
FI / MF :	10.7	10.8	11.1
NON PRO :	3.7	3.5	3.8
PUBLIC & OTHERS :	9.8	9.9	10.6

PRICE VS. SENSEX



CHANGE IN ESTIMATES

	Revised Est.		% Revision	
Rs bn	FY17E	FY18E	FY17E	FY18E
Revenue($ mn)	4,281	4,581	-0.7%	-2.3%
EBITDA	44.0	49.8	-2.7%	-2.0%
Core PAT	28.8	32.4	-3.1%	-3.6%
EPS (Rs)	32.9	37.0	-3.1%	-3.6%

KEY FINANCIALS

Rs bn	FY17E	FY18E	FY19E
Net Sales	288.9	316.1	337.9
EBIDTA	44.0	49.8	55.1
Net Profit	28.8	32.4	36.3
EPS, Rs	32.9	37.0	41.5
PER, x	14.4	12.8	11.4
EV/EBIDTA, x	9.1	7.8	6.7
P/BV, x	2.7	2.4	2.1
ROE, %	19.0	18.7	18.2

Source: PhillipCapital India Research Est.

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Financials

Income Statement

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Net sales	**264,942**	**288,913**	**316,070**	**337,901**
Growth, %	17.1	9.0	9.4	6.9
Employee expenses	-183,257	-199,635	-218,002	-234,346
Other Operating expenses	-38,757	-45,319	-48,296	-48,446
EBITDA (Core)	**42,928**	**43,960**	**49,771**	**55,110**
Growth, %	3.4	2.4	13.2	10.7
Margin, %	16.2	15.2	15.7	16.3
Depreciation	-7,608	-9,537	-10,190	-11,006
EBIT	**35,320**	**34,423**	**39,581**	**44,103**
Growth, %	(0.3)	(2.5)	15.0	11.4
Margin, %	13.3	11.9	12.5	13.1
Interest paid	-972	-1,270	-1,253	-1,253
Other Non-Operating Income	5,144	5,887	4,975	5,883
Pre-tax profit	**39,492**	**39,040**	**43,303**	**48,734**
Tax provided	-8,880	-9,488	-10,503	-11,824
Profit after tax	**30,613**	**29,552**	**32,800**	**36,910**
Others (Minorities, Associates)	-386	-713	-383	-604
Net Profit	**30,226**	**28,839**	**32,417**	**36,306**
Growth, %	15.0	(4.6)	12.4	12.0
Net Profit (adjusted)	**30,226**	**28,839**	**32,417**	**36,306**
Wtd avg shares (m)	865	875	875	875

US$ Revenues

	FY16	FY17E	FY18E	FY19E
US$ Revenue ($ mn)	**4,037**	**4,281**	**4,581**	**4,897**
Growth, %	*10.2*	*6.0*	*7.0*	*6.9*
Re / US$ (rate)	65.6	67.5	69.0	69.0

Balance Sheet

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Cash & bank	40,180	29,393	41,381	60,031
Debtors	57,705	61,261	66,153	71,341
Inventory	403	642	642	642
Other current assets	16,085	12,252	13,231	14,268
Total current assets	141,070	139,786	157,643	182,520
Investments	12,426	12,539	12,539	12,539
Gross fixed assets	49,083	71,929	77,929	83,929
Less: Depreciation	0	0	0	0
Add: Capital WIP	0	0	0	0
Net fixed assets	49,083	71,929	77,929	83,929
Total assets	**224,054**	**244,456**	**268,314**	**299,190**
Current liabilities	22,761	22,360	24,146	26,039
Provisions	8,510	11,954	9,776	10,493
Total current liabilities	31,271	34,315	33,922	36,532
Non-current liabilities	44,902	53,761	55,844	58,053
Total liabilities	76,173	88,075	89,765	94,585
Paid-up capital	4,355	4,377	4,377	4,377
Reserves & surplus	141,590	147,210	169,377	195,434
Minorities	1,936	4,794	4,794	4,794
Shareholders' equity	147,881	156,381	178,549	204,605
Total equity & liabilities	**224,054**	**244,456**	**268,314**	**299,190**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Pre-tax profit	39,492	39,040	43,303	48,734
Depreciation	7,608	9,537	10,190	11,006
Chg in working capital	-1,461	-3,548	-2,002	-2,123
Total tax paid	-23,879	-4,934	-12,682	-11,107
Other operating activities	0	0	0	0
Cash flow from operating activities	**21,761**	**40,095**	**38,810**	**46,510**
Capital expenditure	-10,685	-32,383	-16,190	-17,006
Chg in investments	8,602	-113	0	0
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-2,083**	**-32,496**	**-16,190**	**-17,006**
Free cash flow	19,678	7,599	22,620	29,504
Equity raised/(repaid)	-452	22	0	0
Debt raised/(repaid)	3,275	2,666	0	0
Dividend (incl. tax)	-12,141	-10,242	-10,242	-10,242
Other financing activities	5,823	-12,978	-8	-8
Cash flow from financing activities	**-3,547**	**-18,386**	**-10,632**	**-10,854**
Net chg in cash	16,131	-10,787	11,988	18,650

Valuation Ratios

	FY16	FY17E	FY18E	FY19E
Per Share data				
EPS (INR)	35.0	32.9	37.0	41.5
Growth, %	26.1	(5.7)	12.4	12.0
Book NAV/share (INR)	168.8	173.2	198.5	228.3
CFPS (INR)	37.5	38.9	38.7	46.4
DPS (INR)	12.0	10.0	10.0	10.0
Return ratios				
Return on assets (%)	14.8	13.0	13.1	13.3
Return on equity (%)	20.7	19.0	18.7	18.2
Return on capital employed (%)	17.9	15.1	15.1	15.2
Turnover ratios				
Asset turnover (x)	2.7	2.7	2.6	2.6
Sales/Total assets (x)	1.3	1.2	1.2	1.2
Sales/Net FA (x)	5.6	4.8	4.2	4.2
Working capital/Sales (x)	0.3	0.3	0.3	0.3
Receivable days	79.5	77.4	76.4	77.1
Liquidity ratios				
Current ratio (x)	4.5	4.1	4.6	5.0
Quick ratio (x)	4.5	4.1	4.6	5.0
Dividend cover (x)	2.9	3.3	3.7	4.1
Total debt/Equity (x)	0.1	0.1	0.1	0.1
Net debt/Equity (x)	(0.2)	(0.1)	(0.2)	(0.2)
Valuation				
PER (x)	13.6	14.4	12.8	11.4
PEG (x) - y-o-y growth	0.5	(2.5)	1.0	1.0
Price/Book (x)	2.8	2.7	2.4	2.1
Yield (%)	2.5	2.1	2.1	2.1
EV/Net sales (x)	1.4	1.4	1.2	1.1
EV/EBITDA (x)	8.8	9.1	7.8	6.7
EV/EBIT (x)	10.8	11.6	9.8	8.3

MindTree (MTCL IN)

De-rating to continue, maintain SELL

INDIA | IT SERVICES | Company Update

6 December 2016

Change in fortune in two quarters

MTCL had been our preferred stock in the IT space during FY14-16 due to its impeccable record of reporting industry-leading revenue growth and acquiring companies with niche domain capabilities – commanding premium multiples compared to its large and mid-cap peers. However, its fortune has changed significantly in the last two quarters – coinciding with the change in CEO and top management churn. It has reported below-average revenue performance in H1 with contraction in margin due to client-specific issues, change in macro environment (Brexit), and delay in renewal deals. This has resulted in significant downgrade in earnings and multiple, leading to stock price correction of 35%.

2QFY17 performance casts a dark shadow on its future prospects

MTCL's exceptionally weak performance in Q2 was due to weakness in few clients (across verticals), weakness in Bluefin (primarily due to Brexit), pricing pressure, and delay in renewal deals. All of its verticals reported qoq declines. Margin performance was also extremely weak (EBITDA margins of 12.5% - lowest since Q2FY12); its margins have fallen by ~1000bps in the last 16 quarters. Even on the TCV front it reported the weakest numbers (US$ 184mn) in the last six quarters.

For FY17, the management no longer expects to beat NASSCOM's guidance and does not have enough visibility on margin trajectory. It expects Q3 to be soft as the quarter has holidays and furloughs. We expect weakness to continue in 2HFY17, with the incremental impact of the US elections results and management churn.

Management churn: Big concern

MTCL has a history of unstable management – it has seen churn in top positions every couple of years. In the last few quarters, MTCL has seen multiple top-level exits that have resulted in organisational restructuring. Sep '16 saw two of its top executives (Ms Radha R, Head - Digital, and Mr Veeraraghvan Raghunathapuram, Head - Technology & Media) leaving. Digital (40% of revenues), where MTCL is significantly ahead of its Indian peers and was the fastest growing segment for the company, saw a decline of -2.8% qoq in Q2. We believe the change in top management will have an impact on near-term performance due to transition impact on client-mining and loss of management bandwidth.

Still, a strong digital portfolio will help drive growth

MTCL still has superior delivery capabilities in the digital space vs. its Indian peers –probably because the company was 'born digital'. Its recent acquisitions of Discoverture, Bluefin, Relational, and Magnet 360 are all in the digital space (to enhance delivery capabilities), and have been acquired at inexpensive valuations. Overall, MTCL has a strong digital portfolio, which should drive its growth over the next few years.

Outlook and valuations – good franchise, expensive valuations

MTCL's 1HFY17 result, and more importantly management commentary, alludes to significant headwinds – for both growth and margins. It will no longer be able to report the highest revenue growth in the listed IT services space in FY17 (which it did in FY16). In fact, even its margins are likely to remain under pressure, leading to **ZERO earnings growth over FY15-18**. We expect MTCL's valuations, which have remained rich (relative to peers) at 14.5x FY18 P/E vs. midcap average of 11x to come under pressure.

We introduce FY19 estimates and roll forward our valuation to an average of FY18-19 earnings. We lower our target multiple to 12x (13x earlier) based on macro uncertainties and lower visibility for FY19 estimates. Our target is Rs 410 (Rs 425 earlier). We maintain SELL.

SELL (Maintain)

CMP RS 460

TARGET RS 410 (-9%)

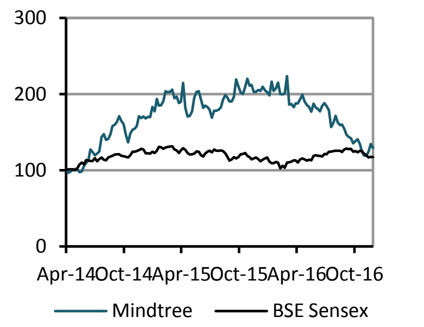
COMPANY DATA

O/S SHARES (MN) :	168
MARKET CAP (RSBN) :	75
MARKET CAP (USDBN) :	1.1
52 - WK HI/LO (RS) :	804 / 400
LIQUIDITY 3M (USDMN) :	5.6
PAR VALUE (RS) :	10

SHARE HOLDING PATTERN, %

	Sep 16	Jun 16	Mar 16
PROMOTERS :	13.7	13.7	13.8
FII / NRI :	39.4	40.9	41.8
FI / MF :	6.7	7.2	6.3
NON PRO :	10.9	10.5	11.0
PUBLIC & OTHERS :	29.4	27.7	27.2

PRICE VS. SENSEX



CHANGE IN ESTIMATES

	Revised Est.		% Revision	
Rs mn	FY17E	FY18E	FY17E	FY18E
Revenue($mn)	786	846	0.0%	-0.7%
EBITDA	7,344	8,397	1.0%	-0.6%
Core PAT	4,659	5,454	1.1%	-0.7%
EPS (Rs)	27.7	32.5	1.1%	-0.7%

KEY FINANCIALS

Rs mn	FY17E	FY18E	FY19E
Net Sales	53,040	58,396	63,100
EBITDA	7,344	8,397	9,265
Net Profit	4,659	5,454	5,975
EPS, Rs	27.7	32.5	35.6
PER, x	16.6	14.2	12.9
EV/EBITDA, x	10.3	8.8	7.7
P/BV, x	2.9	2.6	2.3
ROE, %	17.4	18.1	17.6

Source: PhillipCapital India Research Est.

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Financials

Income Statement

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Net sales	**46,730**	**53,040**	**58,396**	**63,100**
Growth, %	31.2	13.5	10.1	8.1
Other Operating income	0	0	0	0
Total income	46,730	53,040	58,396	63,100
Employee expenses	-27,991	-34,126	-37,549	-40,899
SG&A	-10,529	-11,570	-12,449	-12,935
EBITDA (Core)	**8,210**	**7,344**	**8,397**	**9,265**
Growth, %	15.8	(10.5)	14.3	10.3
Margin, %	17.6	13.8	14.4	14.7
Depreciation	-1,658	-1,877	-2,064	-2,301
EBIT	**6,552**	**5,467**	**6,333**	**6,965**
Growth, %	7.9	(16.6)	15.8	10.0
Margin, %	14.0	10.3	10.8	11.0
Other Non-Operating Income	839	810	847	883
Pre-tax profit	**7,231**	**6,085**	**6,992**	**7,660**
Tax provided	-1,706	-1,426	-1,538	-1,685
Profit after tax	**5,525**	**4,659**	**5,454**	**5,975**
Net Profit	**5,525**	**4,659**	**5,454**	**5,975**
Growth, %	3.0	(15.7)	17.1	9.6
Net Profit (adjusted)	**5,525**	**4,659**	**5,454**	**5,975**
Unadj. shares (m)	168	168	168	168
Wtd avg shares (m)	168	168	168	168

US$ Revenues

	FY16	FY17E	FY18E	FY19E
US$ Revenue ($ mn)	**714**	**786**	**846**	**914**
Growth, %	22.3	10.1	7.6	8.1
Re / US$ (rate)	65.4	67.5	69.0	69.0

Balance Sheet

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Cash & bank	2,332	1,514	3,433	6,068
Debtors	9,728	9,668	10,824	11,599
Loans & advances	3,643	3,591	3,591	3,591
Other current assets	1,149	967	1,082	1,160
Total current assets	16,852	15,740	18,930	22,417
Investments	2,328	3,808	3,808	3,808
Gross fixed assets	11,620	11,219	12,019	12,819
Add: Capital WIP	232	288	288	288
Net fixed assets	11,852	11,507	12,307	13,107
Non-current assets	1,331	1,449	1,449	1,449
Total assets	**32,769**	**33,016**	**37,006**	**41,293**
Current liabilities	6,475	4,072	4,559	4,885
Provisions	1,289	1,629	1,823	1,954
Total current liabilities	7,764	5,701	6,382	6,839
Non-current liabilities	856	568	568	568
Total liabilities	8,620	6,269	6,950	7,407
Paid-up capital	1,678	1,680	1,680	1,680
Reserves & surplus	22,471	25,067	28,376	32,206
Shareholders' equity	24,149	26,747	30,056	33,886
Total equity & liabilities	**32,769**	**33,016**	**37,006**	**41,293**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Pre-tax profit	7,231	6,085	6,992	7,660
Depreciation	1,658	1,877	2,064	2,301
Chg in working capital	-1,814	-2,511	-785	-526
Total tax paid	-2,419	-1,193	-1,343	-1,555
Cash flow from operating activities	**4,656**	**4,258**	**6,928**	**7,880**
Capital expenditure	-7,601	-1,532	-2,864	-3,101
Chg in investments	3,023	-1,480	0	0
Cash flow from investing activities	**-4,578**	**-3,012**	**-2,864**	**-3,101**
Free cash flow	78	1,246	4,064	4,780
Equity raised/(repaid)	541	-306	0	0
Debt raised/(repaid)	-5	-4	0	0
Dividend (incl. tax)	-2,045	-1,755	-2,145	-2,145
Cash flow from financing activities	**-1,509**	**-2,065**	**-2,145**	**-2,145**
Net chg in cash	-1,431	-818	1,919	2,635

Valuation Ratios

	FY16	FY17E	FY18E	FY19E
Per Share data				
EPS (INR)	32.9	27.7	32.5	35.6
Growth, %	2.7	(15.8)	17.0	9.6
Book NAV/share (INR)	143.9	159.3	178.9	201.7
FDEPS (INR)	32.9	27.7	32.5	35.6
CEPS (INR)	42.8	38.9	44.7	49.3
CFPS (INR)	28.1	23.7	36.2	41.6
DPS (INR)	10.5	9.0	11.0	11.0
Return ratios				
Return on assets (%)	19.0	14.5	15.9	15.6
Return on equity (%)	22.9	17.4	18.1	17.6
Return on capital employed (%)	24.7	18.3	19.2	18.7
Turnover ratios				
Asset turnover (x)	2.9	2.6	2.7	2.7
Sales/Total assets (x)	1.6	1.6	1.7	1.6
Sales/Net FA (x)	5.3	4.5	4.9	5.0
Working capital/Sales (x)	0.1	0.2	0.2	0.2
Receivable days	76.0	66.5	67.7	67.1
Payable days	17.9	13.0	13.3	13.2
Working capital days	52.8	58.7	57.0	55.0
Liquidity ratios				
Current ratio (x)	2.2	2.8	3.0	3.3
Quick ratio (x)	2.2	2.8	3.0	3.3
Dividend cover (x)	3.1	3.1	3.0	3.2
Total debt/Equity (%)	1.8	0.1	0.0	0.0
Net debt/Equity (%)	(7.9)	(5.6)	(11.4)	(17.9)
Valuation				
PER (x)	14.0	16.6	14.2	12.9
PEG (x) - y-o-y growth	5.2	(1.1)	0.8	1.4
Price/Book (x)	3.2	2.9	2.6	2.3
Yield (%)	2.3	2.0	2.4	2.4
EV/Net sales (x)	1.6	1.4	1.3	1.1
EV/EBITDA (x)	9.2	10.3	8.8	7.7

NIIT Tech (NITEC IN)

Attractive valuations; bright outlook

INDIA | IT SERVICES | Company Update

6 December 2016

2QFY17 results: strong performance to set base for FY18

NITEC reported strong 2QFY17 results, especially on revenue front. Topline grew 2.3% qoq and margins improved 140bps – both were ahead of expectations. Fresh order bookings also increased to US$ 143mn (US$ 101mn in the last quarter), mainly from the Morris deal renewal of US$ 63mn. While the management expects Q3 to be soft due to a ramp-down in one of the T&T client in the US, H2 is likely to be better than H1.

NITEC's last three quarters' performance was highly disappointing, primarily due to one-offs, ramp-down of government business, and weakness in NITL/GIS. While FY17 USD revenue is likely to be muted at 2% (lowest in our coverage universe), we see growth rebounding strongly in FY18 on robust orderbook, completion of ramp-down of government business, and bottoming out of NITL/GIS business. At highly attractive valuations of 8x FY18 P/E (much lower than midcap average), NITEC looks like an attractive BUY.

Basic framework in place; strong growth likely from FY18

Over the last two years, NITEC has significantly rationalised its portfolio. Ex-COO, Sudhir Chaturvedi's strategy of: (1) cross-selling IMS, (2) expanding the BFSI business in the US, (3) securing a leadership position in the transport vertical, and (4) reducing the low-margin government business, was executed to perfection. Over FY13-16, IMS grew 55%, US' contribution increased to 45% from 37%, government business contribution reduced to 2% from 11%, and hardware revenue reduced to Rs 380mn in FY16 from Rs 730mn in FY13.

Business rationalisation is now complete and current order book of US$ 300mn consists of largely high-margin onsite revenue. While FY17 revenue might still be tepid because of a weak 1QFY17 and lower government business, strong revenue growth in FY18 and beyond is possible based on current order book – this would provide additional levers for margin expansion.

Proxy play on low crude prices; subsidiary performance to improve

Travel and transport constitutes 33% of NITEC's revenues and has been its mainstay. The 70% fall in crude prices over August 2014-January 2016 is likely to benefit airlines immensely and boost their cash reserves – we expect a part of this to be spent on IT solutions (particularly digital) with a lag of 6-12 months and NITEC to be the biggest beneficiary. NITEC has executed end-to-end solutions for 50 leading global airlines (clients), which include operations, enterprise and ticketing solutions, and mobility solutions.

Its lacklustre performance over the last few quarters has been primarily due to underperformance of its subsidiaries – especially NITL and GIS. We believe both these businesses have bottomed out and should report strong growth hereafter, so should its other international subsidiaries (Incessant, Morris, and Proyecta).

The exit of COO Sudhir Chaturvedi is a significant negative

In October 2016, NITEC's COO Mr Sudhir Chaturvedi resigned to pursue other interests. Mr Chaturvedi had joined NITEC in August 2013 from Infosys and was chiefly responsible for the company's turnaround over the last three years. We see his exit as a big setback as the post of COO was created specifically to groom him as the next CEO. With him leaving, the company will probably look to hire someone directly for the CEO post, or perhaps create an interim post, elongating the turnaround process. Scepticism is also likely to surround the terms of engagement of his successor, and whether he/she is given enough rope.

Outlook and valuations – lower visibility, attractive valuations

We introduce FY19 estimates and roll forward our valuation to average of FY18-19 earnings. We maintain our target multiple at 10x. Our target is Rs 500 (from Rs 480). Maintain BUY.

BUY (Maintain)

CMP RS 423

TARGET RS 500 (+18%)

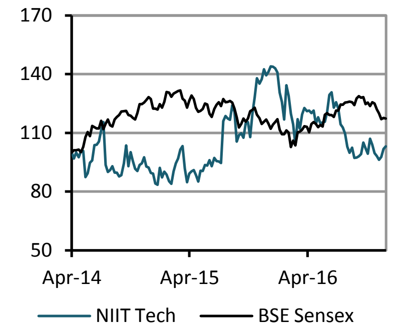
COMPANY DATA

O/S SHARES (MN) :	61
MARKET CAP (RSBN) :	26
MARKET CAP (USDBN) :	0.4
52 - WK HI/LO (RS) :	615 / 367
LIQUIDITY 3M (USDMN) :	3.5
PAR VALUE (RS) :	10

SHARE HOLDING PATTERN, %

	Sep 16	Jun 16	Mar 16
PROMOTERS :	30.7	30.8	30.8
FII / NRI :	29.6	32.7	31.8
FI / MF :	21.5	20.2	21.5
NON PRO :	6.8	6.3	4.3
PUBLIC & OTHERS :	11.3	10.0	11.6

PRICE VS. SENSEX



CHANGE IN ESTIMATES

	Revised Est.		% Revision	
Rs mn	FY17E	FY18E	FY17E	FY18E
Revenue($ mn)	416	445	0.0%	-1.2%
EBITDA	4,555	5,092	0.8%	-0.5%
Core PAT	2,588	2,916	0.8%	-0.6%
EPS (Rs)	42.3	47.7	0.8%	-0.6%

KEY FINANCIALS

Rs mn	FY17E	FY18E	FY19E
Net Sales	28,043	30,700	32,916
EBIDTA	4,555	5,092	5,550
Net Profit	2,588	2,916	3,250
EPS, Rs	42.3	47.7	53.1
PER, x	10.0	8.9	8.0
EV/EBIDTA, x	4.3	3.4	2.7
P/BV, x	1.5	1.3	1.3
ROE, %	15.1	15.2	16.3

Source: PhillipCapital India Research Est.

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Financials

Income Statement

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Net sales	**26,864**	**28,043**	**30,700**	**32,916**
Growth, %	13.2	4.4	9.5	7.2
Employee expenses	-16,949	-18,002	-19,550	-20,846
Other Operating expenses	-5,198	-5,486	-6,059	-6,521
EBITDA (Core)	**4,717**	**4,555**	**5,092**	**5,550**
Growth, %	36.5	-3.4	11.8	9.0
Margin, %	17.6	16.2	16.6	16.9
Depreciation	-1,193	-1,278	-1,337	-1,381
EBIT	**3,524**	**3,277**	**3,755**	**4,169**
Growth, %	38.7	(7.0)	14.6	11.0
Margin, %	13.1	11.7	12.2	12.7
Interest paid	0	0	0	0
Other Non-Operating Income	181	245	327	380
Exceptional Item	0	-361	0	0
Pre-tax profit	**3,705**	**3,161**	**4,082**	**4,549**
Tax provided	-830	-747	-980	-1,092
Profit after tax	**2,875**	**2,414**	**3,103**	**3,457**
Others (Minorities, Associates)	-169	-186	-186	-207
Net Profit	**2,706**	**2,227**	**2,916**	**3,250**
Growth, %	137.6	(4.4)	12.7	11.4
Net Profit (adjusted)	**2,706**	**2,588**	**2,916**	**3,250**
Wtd avg shares (m)	61	61	61	61

US$ Revenues

	FY16	FY17E	FY18E	FY19E
US$ Revenue ($ mn)	**411**	**416**	**445**	**477**
Growth, %	6.0	1.3	6.9	7.2
Re / US$ (rate)	65.4	67.4	69.0	69.0

Balance Sheet

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Cash & bank	5,695	6,465	8,781	10,870
Marketable securities at cost	0	0	0	0
Debtors	5,901	5,762	6,308	6,426
Inventory	52	52	52	52
Other current assets	1,988	1,933	2,069	2,066
Total current assets	15,315	16,069	19,295	21,579
Investments	2,301	2,301	2,301	2,301
Net fixed assets	4,617	4,880	4,343	2,962
Non-current assets	0	0	0	0
Total assets	**22,492**	**23,249**	**25,938**	**26,842**
Total current liabilities	5,837	4,826	5,262	5,356
Non-current liabilities	102	86	96	100
Total liabilities	5,939	4,912	5,358	5,455
Paid-up capital	612	614	614	614
Reserves & surplus	15,296	16,509	18,566	19,324
Minorities	645	1,214	1,400	1,449
Shareholders' equity	16,553	18,337	20,580	21,387
Total equity & liabilities	**22,492**	**23,249**	**25,938**	**26,842**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Pre-tax profit	3,705	3,161	4,082	4,549
Depreciation	1,193	1,278	1,337	1,381
Chg in working capital	-479	-994	-474	-102
Total tax paid	-703	-488	-980	-1,092
Other operating activities	0	361	0	0
Cash flow from operating activities	**3,716**	**3,317**	**3,965**	**4,736**
Capital expenditure	611	-1,541	-800	0
Chg in investments	-1,750	0	0	0
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-1,139**	**-1,541**	**-800**	**0**
Free cash flow	2,577	1,776	3,165	4,736
Equity raised/(repaid)	2	2	0	0
Debt raised/(repaid)	18	-16	10	4
Dividend (incl. tax)	-716	-788	-788	-788
Other financing activities	342	-588	-72	-1,704
Cash flow from financing activities	**-67**	**-1,007**	**-849**	**-2,647**
Net chg in cash	2,510	769	2,316	2,089

Valuation Ratios

	FY16	FY17E	FY18E	FY19E
Per Share data				
EPS (INR)	44.3	42.3	47.7	53.1
Growth, %	136.4	(4.6)	12.6	11.4
Book NAV/share (INR)	260.6	279.9	313.4	325.8
CFPS (INR)	57.9	44.3	59.4	71.2
DPS (INR)	10.0	11.0	11.0	11.0
Return ratios				
Return on assets (%)	13.6	10.6	12.6	13.1
Return on equity (%)	17.0	15.1	15.2	16.3
Return on capital employed (%)	17.2	12.8	14.9	15.4
Turnover ratios				
Asset turnover (x)	2.6	2.7	2.8	3.2
Sales/Total assets (x)	1.3	1.2	1.2	1.2
Sales/Net FA (x)	4.9	5.9	6.7	9.0
Working capital/Sales (x)	0.2	0.2	0.2	0.2
Receivable days	80.2	75.0	75.0	71.3
Liquidity ratios				
Current ratio (x)	3.5	4.4	4.9	5.4
Quick ratio (x)	3.5	4.4	4.9	5.4
Dividend cover (x)	4.4	3.8	4.3	4.8
Total debt/Equity (%)	0.6	0.5	0.5	0.5
Net debt/Equity (%)	(35.2)	(37.3)	(45.3)	(54.0)
Valuation				
PER (x)	9.5	10.0	8.9	8.0
PEG (x) - y-o-y growth	0.1	(2.2)	0.7	0.7
Price/Book (x)	1.6	1.5	1.3	1.3
Yield (%)	2.4	2.6	2.6	2.6
EV/Net sales (x)	0.8	0.7	0.6	0.5
EV/EBITDA (x)	4.3	4.3	3.4	2.7
EV/EBIT (x)	5.8	6.0	4.6	3.6

KPIT (KPIT IN)

Business needs significant rebuilding

INDIA | IT SERVICES | Company Update

6 December 2016

Does not seem to be able to grow organically; inorganic route leads to cash-flow issues

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

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

ERP business – lack of management foresight

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

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

2QFY17 results – strong performance, but outlook remains grim

KPIT reported strong performance for Q2FY17, after subdued performance in the last quarter. USD revenue increased 3.1% qoq and margins expanded 35bps to 11%. Its top client (Cummins) grew 5.4% (after three consecutive quarters of decline), while its mainstay, the automotive division, also reported a significant growth (+8.7% qoq). However, management indicated weak Q3FY17 (revenue growth) due to seasonality (holidays, furloughs) and a return to higher revenue growth in Q4FY17. It expects margin to expand significantly from current levels, driven by revenue growth, higher utilization and lower sub-contracting expenses.

Business requires significant rebuilding

We expect the road to revival for KPIT to be long-drawn from here – especially when the only growth engine that appears to be working is the automotive division (ignoring the high quarterly volatility), which has been KPIT's mainstay. Even if the company is able to match its Q2 topline in the next two quarters (difficult with a seasonally weak Q3), it would only be able to match its FY16 topline of US$ 490mn in FY17. This would also mean that **KPIT would end up reporting zero revenue growth over the last three years**. Margins are also expected to remain under pressure, leading to little scope for rerating.

Outlook and valuation

We are 13/20% below consensus on FY18/19 PAT estimates, with the street STILL baking in high levels of optimism in numbers. We expect significant downgrade to consensus estimates through the year. We introduce FY19 estimates and roll-forward our valuation to average of FY18-19 earnings. We maintain our target multiple at 9x. Our target is Rs 120 (unchanged). Maintain SELL.

SELL (Maintain)

CMP RS 132

TARGET RS 120 (-9%)

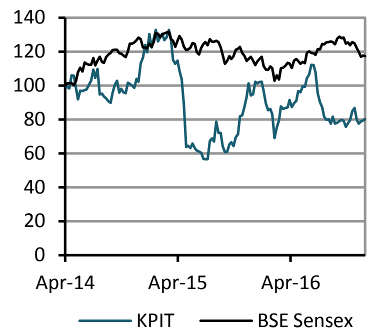
COMPANY DATA

O/S SHARES (MN) :	197
MARKET CAP (RSBN) :	26
MARKET CAP (USDBN) :	0.4
52 - WK HI/LO (RS) :	197 / 108
LIQUIDITY 3M (USDMN) :	2.1
PAR VALUE (RS) :	2

SHARE HOLDING PATTERN, %

	sep 16	Jun 16	Mar 16
PROMOTERS :	16.7	16.7	16.8
FII / NRI :	51.0	52.7	49.9
FI / MF :	1.4	1.5	1.7
NON PRO :	15.9	13.0	16.1
PUBLIC & OTHERS :	15.0	16.1	15.5

PRICE VS. SENSEX



CHANGE IN ESTIMATES

	Revised Est.		% Revision	
Rs mn	FY17E	FY18E	FY17E	FY18E
Revenue($ mn)	489	514	0.0%	-1.8%
EBITDA	3,829	4,273	0.7%	-1.7%
Core PAT	2,345	2,626	0.8%	-1.5%
EPS (Rs)	11.7	13.1	0.8%	-1.5%

KEY FINANCIALS

Rs mn	FY17E	FY18E	FY19E
Net Sales	33,075	35,464	37,400
EBIDTA	3,829	4,273	4,684
Net Profit	2,345	2,627	2,903
EPS, Rs	11.7	13.1	14.5
PER, x	11.3	10.1	8.7
EV/EBIDTA, x	6.6	5.5	4.5
P/BV, x	1.6	1.4	1.2
ROE, %	14.9	14.5	13.8

Source: PhillipCapital India Research Est.

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Financials

Income Statement

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Net sales	**32,256**	**33,075**	**35,464**	**37,400**
Growth, %	7.9	2.5	7.2	5.5
Employee expenses	-23,317	-24,660	-26,188	-28,560
Other Operating expenses	-4,593	-4,586	-5,003	-4,156
EBITDA (Core)	**4,346**	**3,829**	**4,273**	**4,684**
Growth, %	34.0	(11.9)	11.6	9.6
Margin, %	13.5	11.6	12.1	12.5
Depreciation	-691	-786	-822	-866
EBIT	**3,655**	**3,043**	**3,452**	**3,818**
Growth, %	52.8	(16.8)	13.4	10.6
Margin, %	11.3	9.2	9.7	10.2
Interest paid	-156	-144	-148	-148
Other Non-Operating Income	172	255	295	306
Pre-tax profit	**3,671**	**3,154**	**3,598**	**3,976**
Tax provided	-826	-810	-972	-1,074
Profit after tax	**2,846**	**2,345**	**2,627**	**2,903**
Others (Minorities, Associates)	0	0	0	0
Net Profit	**2,846**	**2,345**	**2,627**	**2,903**
Growth, %	20.9	(17.6)	12.0	10.5
Net Profit (adjusted)	**2,846**	**2,345**	**2,627**	**2,903**
Wtd avg shares (m)	188	192	192	192

US$ Revenues

	FY16	FY17E	FY18E	FY19E
US$ Revenue ($ mn)	**490**	**489**	**514**	**542**
Growth, %	0.3	(0.2)	5.0	5.5
Re / US$ (rate)	65.8	67.6	69.0	69.0

Balance Sheet

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Cash & bank	3,953	5,001	6,666	9,102
Marketable securities at cost	0	0	0	0
Debtors	6,861	8,138	8,753	9,227
Inventory	0	0	0	0
Other current assets	1,963	2,219	2,386	2,515
Total current assets	12,777	15,358	17,805	20,844
Investments	0	0	0	0
Net fixed assets	6,875	6,283	6,661	6,995
Non-current assets	2,300	3,322	3,322	3,322
Total assets	**21,952**	**24,963**	**27,788**	**31,160**
Total current liabilities	5,974	5,490	5,918	6,389
Non-current liabilities	2,171	3,704	3,704	3,704
Total liabilities	8,145	9,194	9,622	10,093
Paid-up capital	386	386	386	386
Reserves & surplus	13,422	15,383	17,779	20,681
Minorities	0	0	0	0
Shareholders' equity	13,808	15,769	18,165	21,067
Total equity & liabilities	**21,952**	**24,963**	**27,787**	**31,160**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Pre-tax profit	3,671	3,154	3,598	3,976
Depreciation	691	786	822	866
Chg in working capital	532	-3,136	-353	-132
Total tax paid	-733	-708	-971	-1,073
Other operating activities	0	0	0	0
Cash flow from operating activities	**4,162**	**96**	**3,095**	**3,636**
Capital expenditure	-150	-194	-1,200	-1,200
Chg in investments	590	0	0	0
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**440**	**-194**	**-1,200**	**-1,200**
Free cash flow	4,602	-98	1,895	2,436
Equity raised/(repaid)	-7	-1	0	0
Debt raised/(repaid)	-2,286	1,530	0	0
Dividend (incl. tax)	-480	-480	-480	-480
Other financing activities	-1,513	97	233	478
Cash flow from financing activities	**-4,286**	**1,146**	**-247**	**-2**
Net chg in cash	316	1,048	1,648	2,435

Valuation Ratios

	FY16	FY17E	FY18E	FY19E
Per Share data				
EPS (INR)	14.2	11.7	13.1	14.5
Growth, %	20.4	(19.2)	12.0	10.5
Book NAV/share (INR)	73.5	82.3	94.8	110.0
CFPS (INR)	21.9	4.5	14.6	17.4
DPS (INR)	2.2	2.2	2.2	2.2
Return ratios				
Return on assets (%)	13.2	10.4	10.3	10.2
Return on equity (%)	20.6	14.9	14.5	13.8
Return on capital employed (%)	17.6	13.7	13.2	12.8
Turnover ratios				
Asset turnover (x)	3.0	3.0	2.9	2.9
Sales/Total assets (x)	1.4	1.4	1.3	1.3
Sales/Net FA (x)	4.5	5.0	5.5	5.5
Working capital/Sales (x)	0.1	0.1	0.1	0.1
Receivable days	77.6	89.8	90.1	90.0
Liquidity ratios				
Current ratio (x)	2.1	2.8	3.0	3.3
Quick ratio (x)	2.1	2.8	3.0	3.3
Interest cover (x)	23.4	21.1	23.3	25.8
Dividend cover (x)	6.9	5.7	6.4	7.0
Total debt/Equity (%)	15.7	23.5	20.4	17.6
Net debt/Equity (%)	(12.9)	(8.2)	(16.2)	(25.6)
Valuation				
PER (x)	9.3	11.3	10.1	8.7
PEG (x) - y-o-y growth	0.5	(0.6)	0.8	0.8
Price/Book (x)	1.8	1.6	1.4	1.2
Yield (%)	1.7	1.6	1.6	1.6
EV/Net sales (x)	0.8	0.8	0.7	0.6
EV/EBITDA (x)	5.7	6.6	5.5	4.5
EV/EBIT (x)	6.7	8.3	6.8	5.5

Persistent (PSYS IN)

Buying growth with margins; expensive valuations

INDIA | IT SERVICES | Company Update

6 December 2016

Buying out growth with margins

PSYS has been chasing growth at the expense of margins – its EBITDA margins have declined by a whopping 1150bps over the last ten quarters to support revenue CQGR of 4.7% (2.2% organic, excluding Aepona and the IBM deal). Even recent growth from the IBM IoT deal has come at a cost of +250bps to margins. We do not like the quality of growth (which is not significantly ahead of the industry anyway) and believe that it will not be easy for PSYS to recover margins, which have plummeted to 15.7% in 2QFY17 (from 27% in 4QFY14).

Long road to enter the enterprise segment

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

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

Slowdown in organic IP business over the last six quarters is likely to continue

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

Muted 2QFY17 performance

Persistent reported muted revenue growth of 0.4% qoq due to weak performance in IBM (-1.7% qoq). However, its EBITDA margins expanded 80bps to 15.7% – still a decline of 1,150bps over the last ten quarters. IT services revenues was impacted by 3% due to closure of non-strategic accounts. Management expects US$ 50mn revenue in FY17 from the IBM-Watson deal.

Expensive valuations; maintain SELL

At current levels, the stock is trading at 14x our FY18 earnings estimates (we are 6%/16% below consensus estimates for FY18/19), a significant premium to its historical average to the IT-midcap average, and to all the large cap companies (excluding TCS), which have a much more diversified profile, higher margins, and superior return ratios.

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

We introduce FY19 estimates and roll forward our valuation to an average of FY18-19 earnings. We lower our target multiple to 12x (13x earlier) based on macro uncertainties and lower visibility for FY19 estimates. Our target price is Rs 540 (from Rs 600). Maintain SELL.

SELL (Maintain)

CMP RS 595

TARGET RS 540 (-9%)

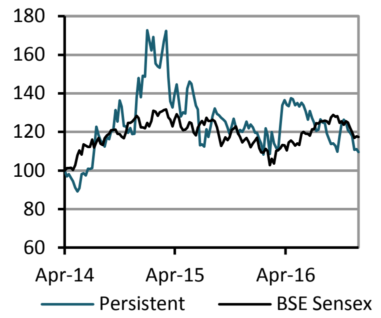
COMPANY DATA

O/S SHARES (MN) :	80
MARKET CAP (RSBN) :	48
MARKET CAP (USDBN) :	0.7
52 - WK HI/LO (RS) :	797 / 501
LIQUIDITY 3M (USDMN) :	0.7
PAR VALUE (RS) :	10

SHARE HOLDING PATTERN, %

	Sep 16	Jun 16	Mar 16
PROMOTERS :	37.9	38.1	38.5
FII / NRI :	22.2	22.6	22.1
FI / MF :	12.3	12.1	12.0
NON PRO :	14.5	14.4	9.9
PUBLIC & OTHERS :	13.1	12.9	12.9

PRICE VS. SENSEX



CHANGE IN ESTIMATES

	Revised Est.		% Revision	
Rs bn	FY17E	FY18E	FY17E	FY18E
Revenue($ mn)	426	460	0.0%	0.0%
EBITDA	4,589	5,196	0.8%	2.8%
Core PAT	3,129	3,485	0.8%	2.2%
EPS (Rs)	39.1	43.6	0.8%	2.2%

KEY FINANCIALS

Rs mn	FY17E	FY18E	FY19E
Net Sales	28,727	31,731	33,999
EBIDTA	4,589	5,196	5,647
Net Profit	3,129	3,485	3,780
EPS, Rs	39.1	43.6	47.2
PER, x	15.2	13.7	12.6
EV/EBIDTA, x	10.0	8.8	7.9
P/BV, x	2.5	2.2	2.0
ROE, %	16.6	16.3	15.6

Source: PhillipCapital India Research Est.

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Financials

Income Statement

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Net sales	**23,123**	**28,727**	**31,731**	**33,999**
Growth, %	22.3	24.2	10.5	7.1
Employee expenses	-14,305	-18,522	-20,373	-21,700
Other Operating expenses	-4,648	-5,616	-6,162	-6,652
EBITDA (Core)	**4,171**	**4,589**	**5,196**	**5,647**
Growth, %	6.8	10.0	13.2	8.7
Margin, %	18.0	16.0	16.4	16.6
Depreciation	-965	-1,505	-1,648	-1,904
EBIT	**3,206**	**3,085**	**3,549**	**3,743**
Growth, %	8.0	(3.8)	15.0	5.5
Margin, %	13.9	10.7	11.2	11.0
Interest paid	0	0	0	0
Other Non-Operating Income	604	880	938	1,136
Pre-tax profit	**3,956**	**4,167**	**4,647**	**5,039**
Tax provided	-983	-1,038	-1,162	-1,260
Profit after tax	**2,974**	**3,129**	**3,485**	**3,780**
Others (Minorities, Associates)	0	0	0	0
Net Profit	**2,974**	**3,129**	**3,485**	**3,780**
Growth, %	2.3	5.2	11.4	8.5
Net Profit (adjusted)	**2,974**	**3,129**	**3,485**	**3,780**
Wtd avg shares (m)	80	80	80	80

US$ Revenues

	FY16	FY17E	FY18E	FY19E
US$ Revenue ($ mn)	**352**	**426**	**460**	**493**
Growth, %	14.0	21.0	8.0	7.1
Re / US$ (rate)	65.8	67.5	69.0	69.0

Balance Sheet

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Cash & bank	1,439	1,776	1,802	2,834
Marketable securities at cost	0	0	0	0
Debtors	4,275	4,503	5,143	5,525
Inventory	0	0	0	0
Other current assets	3,205	2,978	2,978	2,978
Total current assets	10,049	10,486	11,431	12,957
Investments	6,384	6,634	7,634	8,634
Net fixed assets	4,637	5,850	6,602	7,098
Non-current assets	0	0	0	0
Total assets	**21,247**	**23,152**	**25,850**	**28,871**
Total current liabilities	4,594	4,269	4,418	4,597
Non-current liabilities	27	0	0	0
Total liabilities	4,621	4,269	4,418	4,597
Paid-up capital	800	800	800	800
Reserves & surplus	15,826	18,082	20,631	23,475
Minorities	0	0	0	0
Shareholders' equity	16,626	18,882	21,431	24,275
Total equity & liabilities	**21,247**	**23,152**	**25,850**	**28,871**

Source: Company, PhillipCapital India Research Estimates

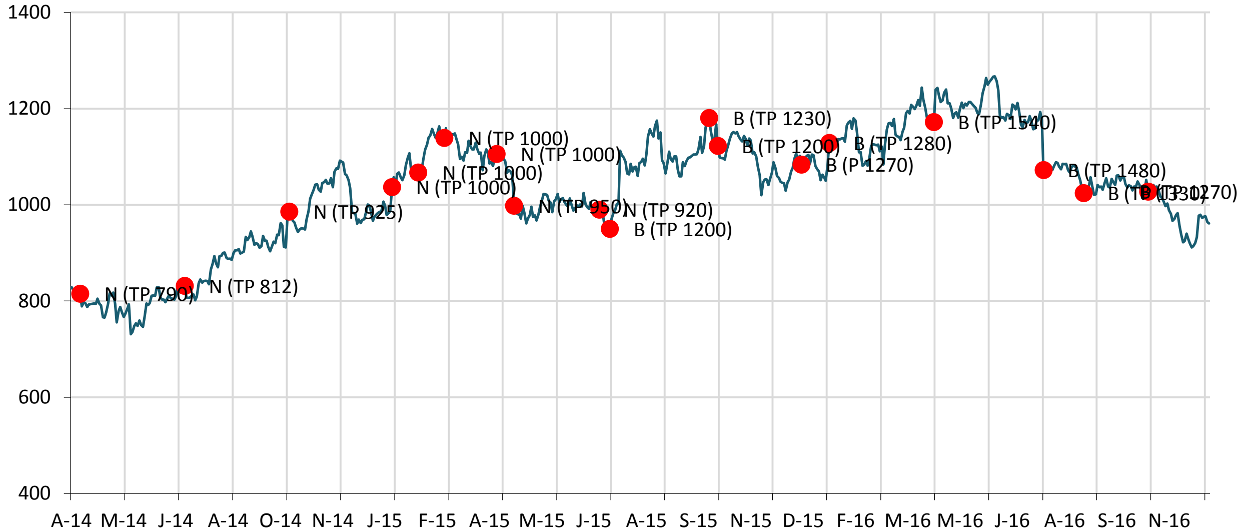
Cash Flow

Y/E Mar, Rs mn	FY16	FY17E	FY18E	FY19E
Pre-tax profit	3,956	4,167	4,647	5,039
Depreciation	965	1,505	1,648	1,904
Chg in working capital	-2,494	-450	-771	-316
Total tax paid	-845	-1,043	-1,162	-1,260
Other operating activities	0	0	0	0
Cash flow from operating activities	**1,583**	**4,178**	**4,362**	**5,368**
Capital expenditure	-1,509	-2,718	-2,400	-2,400
Chg in investments	352	-251	-1,000	-1,000
Chg in marketable securities	0	0	0	0
Other investing activities	0	0	0	0
Cash flow from investing activities	**-1,157**	**-2,968**	**-3,400**	**-3,400**
Free cash flow	425	1,210	962	1,968
Equity raised/(repaid)	0	0	0	0
Debt raised/(repaid)	0	0	0	0
Dividend (incl. tax)	-749	-843	-936	-936
Other financing activities	346	-30	0	0
Cash flow from financing activities	**-403**	**-873**	**-936**	**-936**
Net chg in cash	23	338	26	1,032

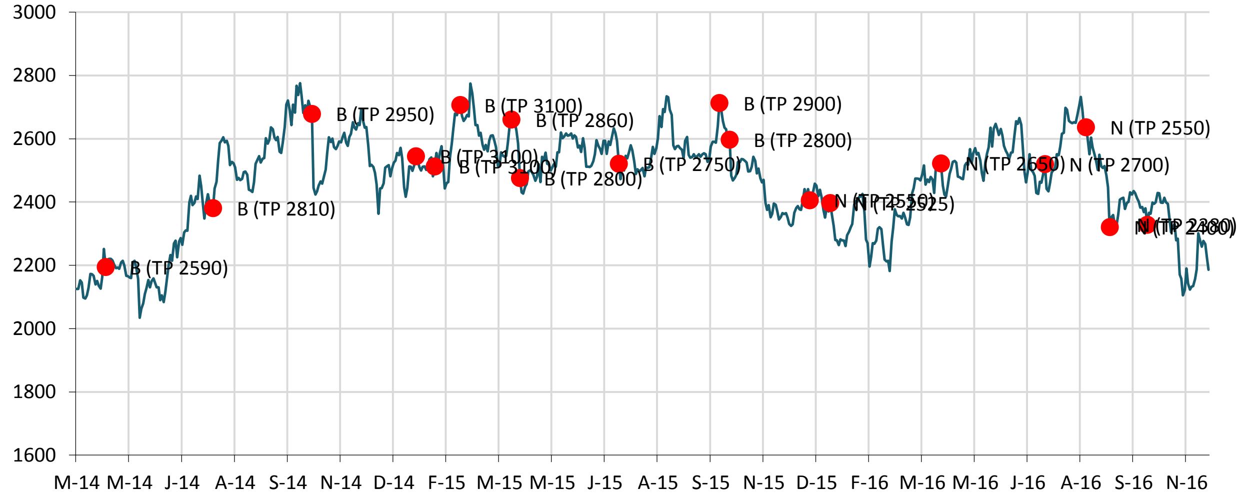
Valuation Ratios

	FY16	FY17E	FY18E	FY19E
Per Share data				
EPS (INR)	37.2	39.1	43.6	47.2
Growth, %	2.3	5.2	11.4	8.5
Book NAV/share (INR)	207.8	236.0	267.9	303.4
CFPS (INR)	11.9	41.2	42.8	52.9
DPS (INR)	8.0	9.0	10.0	10.0
Return ratios				
Return on assets (%)	15.3	14.1	14.2	13.8
Return on equity (%)	17.9	16.6	16.3	15.6
Return on capital employed (%)	17.5	16.3	16.2	15.6
Turnover ratios				
Asset turnover (x)	2.7	2.7	2.5	2.5
Sales/Total assets (x)	1.2	1.3	1.3	1.2
Sales/Net FA (x)	5.3	5.5	5.1	5.0
Working capital/Sales (x)	0.2	0.2	0.2	0.2
Receivable days	67.5	57.2	59.2	59.3
Liquidity ratios				
Current ratio (x)	3.1	3.7	3.8	4.1
Quick ratio (x)	3.1	3.7	3.8	4.1
Dividend cover (x)	4.6	4.3	4.4	4.7
Net debt/Equity (%)	(8.7)	(9.4)	(8.4)	(11.7)
Valuation				
PER (x)	16.0	15.2	13.7	12.6
PEG (x) - y-o-y growth	6.9	2.9	1.2	1.5
Price/Book (x)	2.9	2.5	2.2	2.0
Yield (%)	1.3	1.5	1.7	1.7
EV/Net sales (x)	2.0	1.6	1.4	1.3
EV/EBITDA (x)	11.1	10.0	8.8	7.9
EV/EBIT (x)	14.4	14.9	12.9	12.0

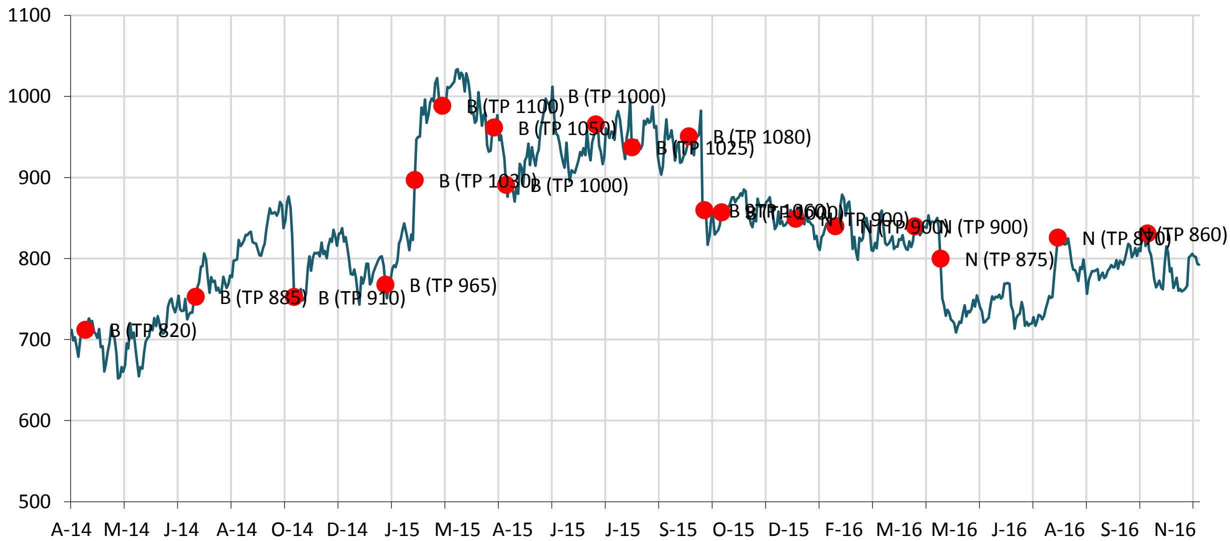
Stock Price, Price Target and Rating History (Infosys)



Stock Price, Price Target and Rating History (TCS)



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



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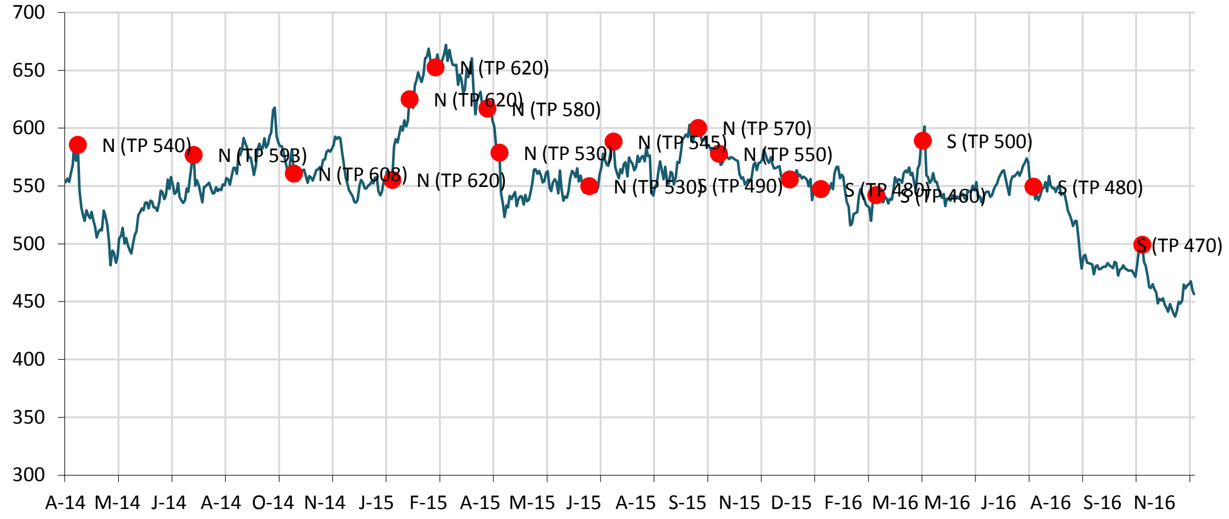

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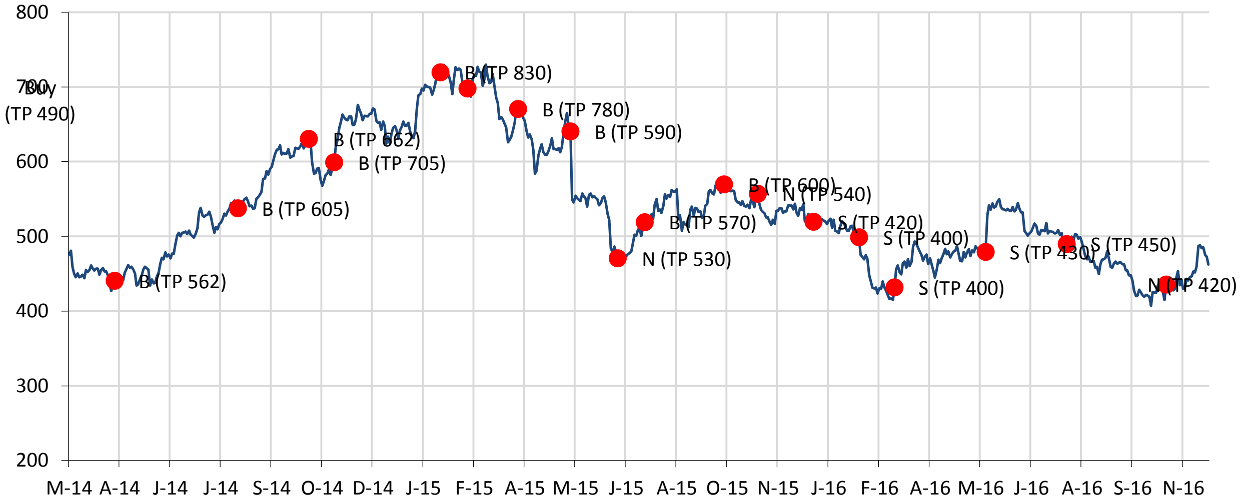

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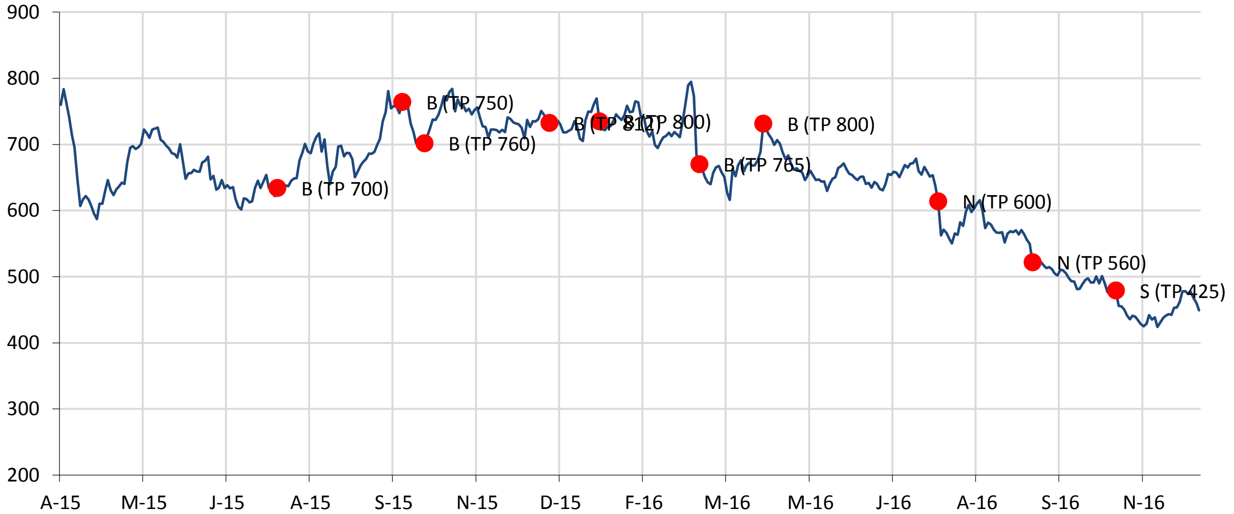

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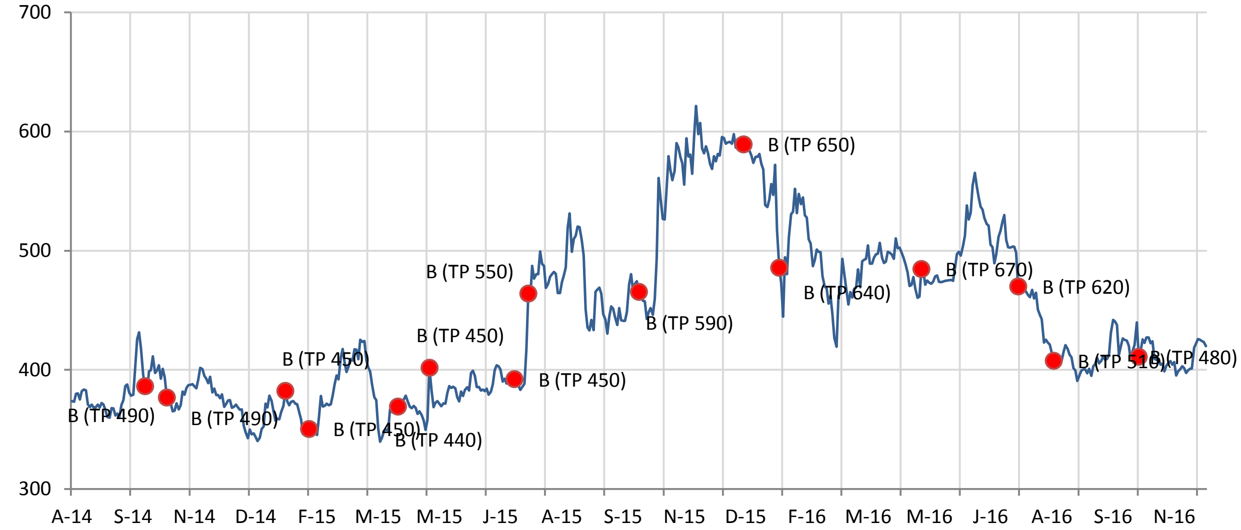
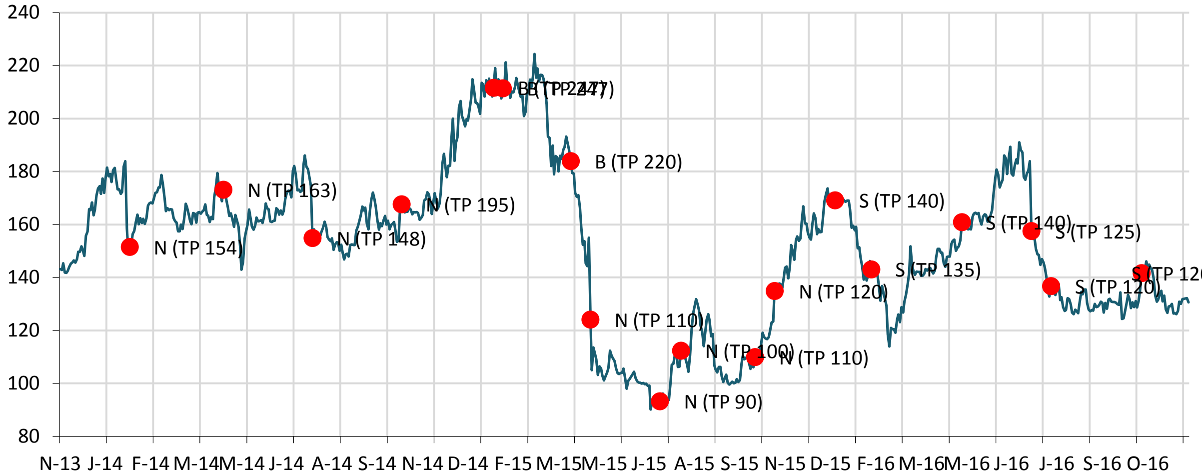
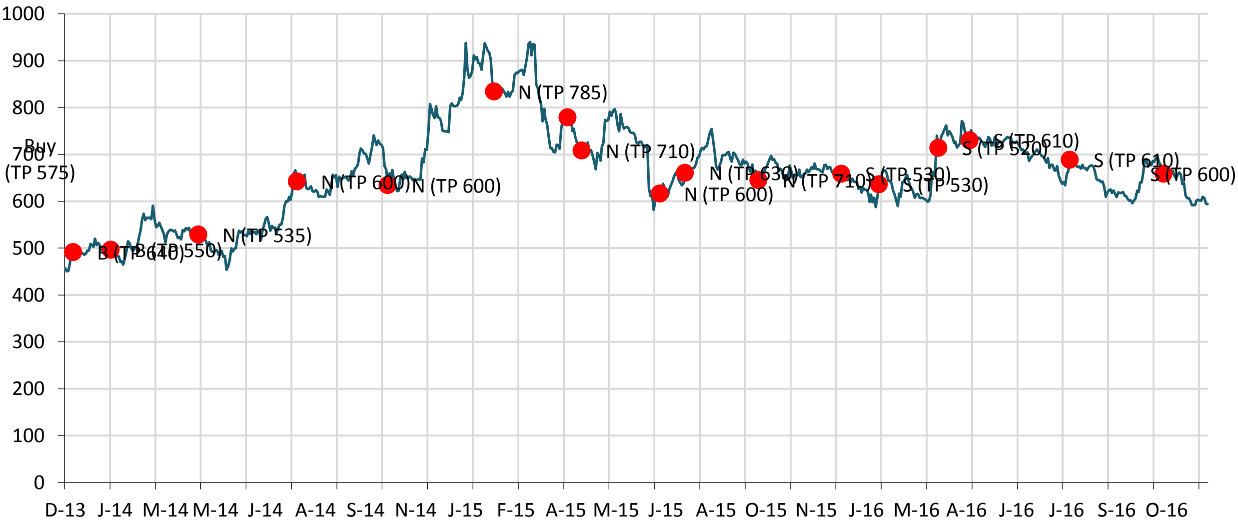


Stock Price, Price Target and Rating History (KPIT)



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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