IT Services

The party continues …

PhillipCapital

PhillipCapital (India) Pvt. Ltd.

2QFY14 Results Review

31 October 2013

The second quarter of FY14 turned out to be a strong one for the IT sector, especially for the top 4. While most companies delivered in-line or **better than expected $ revenue growth**, the **favorable Rupee depreciation** and **operational efficiencies** helped them post **robust margins**.

With **Europe showing signs of opening up to the outsourcing model**, most of the companies are looking at a healthy deal pipeline. While signs of revival in discretionary spending in US are still at nascent level, **non-discretionary domains like IMS continued to lead growth momentum**. Amongst the verticals, Manufacturing and Retail led the growth to a large extent.

TCS: Reported a robust **5.4% QoQ growth in $ revenue** – inline with street expectations. **Margins expanded by 300bps**, aided by Rupee depreciation and operational efficiencies. US grew by 3.7%, **EU by 11.7%** and UK by 7.3% on QoQ basis. In the verticals, **BFSI grew by 5.7%** while Manufacturing and Retail reported 5.4% and 4.7% growth respectively. The company maintained its earlier guidance of outperforming the industry growth rate, pegged at 12-14% by NASSCOM, and expects holidays and furloughs in 3Q to dampen the growth to some extent.

Infosys: Reported a mixed set of numbers with **3.8% growth in $ revenues** – ahead of street estimates. However, **margins declined by 200bps QoQ**, on the back of exceptional visa expense and provision for bonuses. Americas grew by 3.9%, **EU by 3.8%** and India by 6.2% on QoQ basis. In the verticals, **Manufacturing grew by 6.6%** while BFSI and ECS reported 3.9% and 5.6% growth respectively. The management narrowed its earlier guidance of 6-10% $ revenue growth to 9-10% and has communicated their strategy to chase growth, even if at the expense of margins.

Wipro: Reported strong set of numbers, with **2.7% QoQ growth in $ revenue** – at mid-point of their guidance. **EBIT Margins expanded by 260bps QoQ** – driven by Rupee depreciation and operational efficiencies. **US grew by 2.9% QoQ**, EU by 2.3% and EM by 6.8%. Amongst service lines, IMS grew by 2.7% and **Business App Srvc by 4.7%.** Growth in Verticals was led by **Telecom (+4.9%),** BFSI (+2.3%) and Manufacturing (+2.2%). The company has guided to a $ revenue growth of 1.8% – 3.6% for Q3FY14 – a very strong guidance, especially give that Q3 is traditionally a weaker quarter.

HCL Tech: Continued to report strong numbers with **3.5% growth in $ revenue** – inline with expectations. **Margins expanded by 300bps QoQ** – with only -50bps impact of salary hike in this quarter (-120bps expected in 3Q). **US grew by 4%,** EU by 1% and Emerging Markets by 8.5% QoQ. Amongst verticals, **BFSI grew by 6.9%,** Manufacturing by 5.4% and Life sciences by 6.5% QoQ. Amongst service lines, **IMS continued to lead with 8.8% QoQ growth,** while Software services grew by 1.1%.

Overall, we believe that early signs of revival in US and **newer avenues (Europe and Australia)** will preserve the growth momentum for the sector. With the salary hikes having been awarded for most companies and Rupee at current levels, the **margins should also remain stable** for the remaining half of FY14. Overall, we remain positive on the sector and expect it to outperform the broader index. Out **top picks are HCL Tech and TCS** in the large-cap and **Persistent Systems** in the midcap space.

Companies Covered

TCS	
CMP	Rs2095
Rating	BUY
TP	Rs2400
HCL Tech	
CMP	Rs1085
Rating	BUY
TP	Rs1260
Infosys	
CMP	Rs3324
Rating	NEUTRAL
TP	Rs2970
Wipro	
CMP	Rs477
Rating	NEUTRAL
TP	Rs500
Persistent Systems	
CMP	Rs802
Rating	BUY
TP	Rs840
KPIT Cummins	
CMP	Rs147
Rating	BUY
TP	Rs162

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Q2FY14 Results Review – Large caps

	Actual			Consensus		
Rs mn	**Q2FY14**	**Q1FY14**	**QoQ**	**Q2FY14E**	**Deviation**	**Comments**
TCS						
$ revenues	**3,337**	**3,165**	**5.4%**	**3,339**	**-0.1%**	Rev inline, with robust volume growth of 7.3% QoQ, broadbased
INR revenues	209,772	179,871	16.6%	207,000	1.3%	growth in all segments
EBITDA	66,390	51,532	28.8%	64,300	3.3%	Margins came slightly higher than expectations, on better
EBITDA margins	**31.6%**	**28.6%**	**300bps**	**31.1%**	**59bps**	operational efficiencies
PAT	47,018	37,962	23.9%	44,700	5.2%	FX loss of Rs3.2bn (lower than expected) led to PAT growth of 24%
EPS	**24.0**	**19.4**		**22.8**		
Infosys						
$ revenues	**2,066**	**1,991**	**3.8%**	**2,039**	**1.3%**	Rev surprised positively with an overall volume growth of 2.6%
INR revenues	129,650	112,670	15.1%	127,000	2.1%	QoQ and realization growth of 1.2%
EBITDA	31,700	29,830	6.3%	36,600	-13.4%	Despite having a 250bps rupee support, the higher wage hikes and
EBITDA margins	**24.5%**	**26.5%**	**-203bps**	**28.8%**	**-430bps**	exceptional visa charge provisions took toll in margins
PAT	24,070	23,740	1.4%	26,310	-8.5%	PAT had an additional impact of higher taxes, 28.1% vs 26.8% in Q1
EPS	**42.1**	**41.6**		**45.0**		
Wipro						
$ revenues - (IT Services)	**1,631**	**1,588**	**2.7%**	**1,625**	**0.4%**	Wipro $ revenues came inline with its guidance. In CC terms, the
INR revenues (consol)	107,727	97,294	10.7%	109,500	-1.6%	topline grew by 3.2% QoQ
EBIT	22,422	17,702	26.7%	21,350	5.0%	The margin expansion of 260bps was mainly due to rupee
EBIT margins	**20.8%**	**18.2%**	**262bps**	**19.5%**	**132bps**	depreciation. The negative impact of wage hikes were completely compensated by the operational efficiencies in the quarter
PAT - adj	19,320	16,233	19.0%	18,500	4.4%	Tax rates at 22.9% were slightly higher than last quarter (20.7%)
EPS	**7.9**	**6.6**		**7.5**		
HCL Tech						
$ revenues	**1,270**	**1,228**	**3.5%**	**1,263**	**0.6%**	$ Revenue growth was inline. In CC terms, revenues grew by 3.6%
INR revenues	79,610	69,800	14.1%	78,300	1.7%	QoQ
EBITDA	20,930	16,150	29.6%	19,400	7.9%	EBITDA margins expanded mainly due to rupee depreciation
EBITDA margins	**26.3%**	**23.1%**	**315bps**	**24.8%**	**150bps**	(250bps) and operational efficiencies (100bps), despite wage impact of 50bps. 120bps impact of wage hikes is expected in 3Q.
PAT	14,160	11,930	18.7%	13,200	7.3%	FX loss of Rs2.4bn impacted PAT, while lower tax rates and higher
EPS	**20.0**	**16.9**		**18.8**		other income (increase in treasury income) supported it.

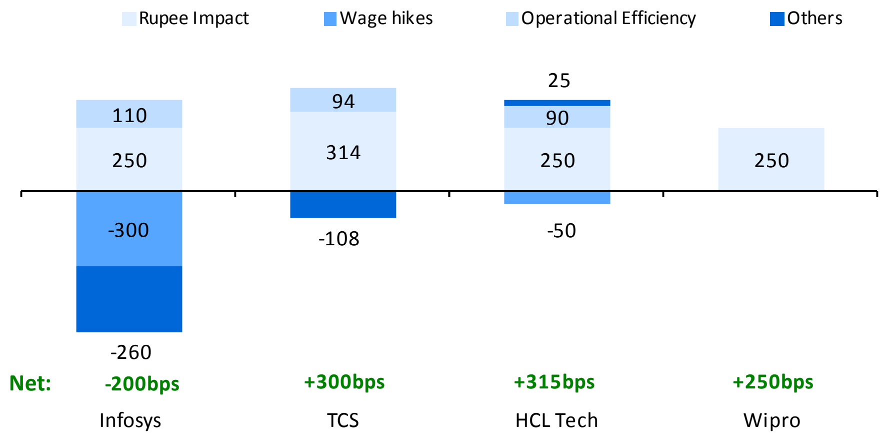
Segmental Performance

Verticals	BFSI		Manufacturing		Retail		Telecom	
	QoQ	YoY	QoQ	YoY	QoQ	YoY	QoQ	YoY
TCS	5.7%	18%	4.7%	14%	4.8%	19%	2.1%	6%
Infosys	2.8%	14%	7.0%	21%	3.2%	8%	1.3%	-4%
HCL Tech	6.3%	23%	5.4%	38%	-0.1%	3%	-6.8%	38%
Wipro	2.3%	4%	2.2%	6%	0.7%	4%	5.0%	2%
Top 4	**4.6%**	**15%**	**5.0%**	**20%**	**3.1%**	**11%**	**1.4%**	**6%**
Services	**ADM**		**EAS**		**IMS**		**BPO**	
TCS	3.9%	13%	6.0%	22%	4.5%	21%	5.4%	10%
Infosys	4.1%	5%	2.8%	28%	6.7%	22%	3.8%	21%
HCL Tech	0.6%	4%	1.1%	-1%	8.7%	42%	3.5%	9%
Wipro	0.7%	-3%	4.7%	10%	2.7%	10%	0.4%	5%
Top 4	**3.1%**	**8%**	**4.1%**	**18%**	**5.5%**	**23%**	**4.0%**	**11%**

Geography	Americas		Europe		RoW	
	QoQ	YoY	QoQ	YoY	QoQ	YoY
TCS	3.7%	18%	11.7%	25%	1.6%	4%
Infosys	3.9%	11%	5.5%	26%	0.3%	17%
HCL Tech	3.8%	14%	2.5%	23%	4.3%	-5%
Wipro	2.9%	2%	2.4%	9%	2.6%	11%
Top 4	**3.6%**	**12%**	**6.8%**	**21%**	**1.8%**	**7%**

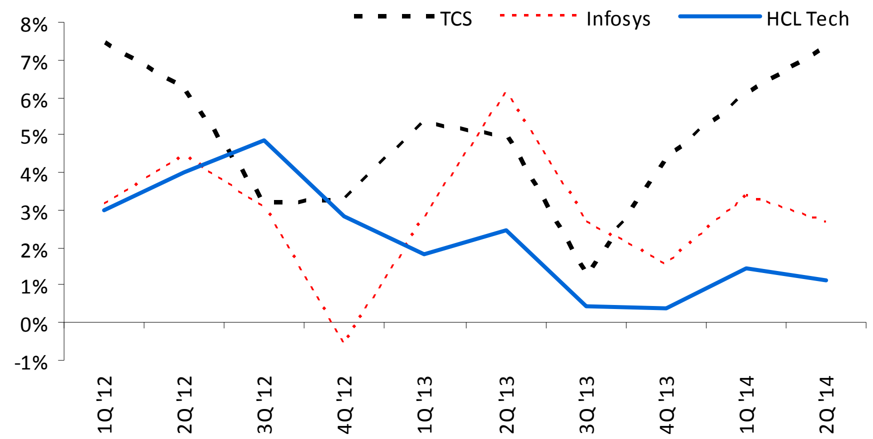
Source: PhillipCapital India Research

2QFY14 Margin Impact Analysis



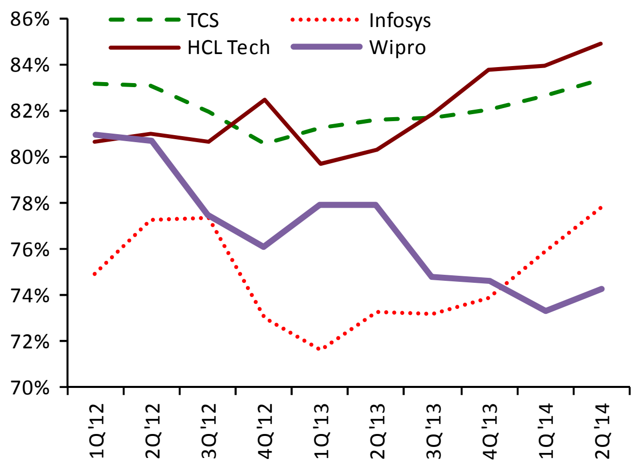
Source: Company, PhillipCapital India Research

Volumes having bottomed-out, trending up

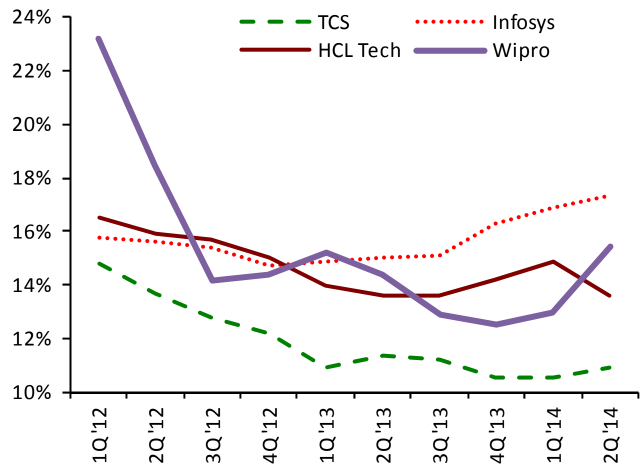


Source: PhillipCapital India Research

HCL Tech and TCS running on peak utilizations



Attrition remains low for TCS



Source: PhillipCapital India Research

Midcap Radar

The midcap segment (under our coverage) reported mixed set of numbers, with one company delivering robust set of results, while the other falling short of expectations.

Persistent: Strong set of numbers with 8.6% QoQ growth in $ revenues – significantly ahead of expectations. The growth was led by IP led revenues, which grew 38% QoQ. Margins expanded by a whopping 421bps – led by Rupee depreciation and operational efficiencies. The outlook remains robust and the management guided to a better 2H than 1H, inspite of fewer working days in 3Q.

KPIT Tech: Muted set of numbers, with 3.1% QoQ growth in $ revenues – inline with expectations. However, margin declined by 37bps QoQ – led by expenditure on training and non-recurring provision for delayed ERP project. The management did not revisit their earlier guidance, which stand at $465-475mn topline and Rs2.31-2.39bn PAT.

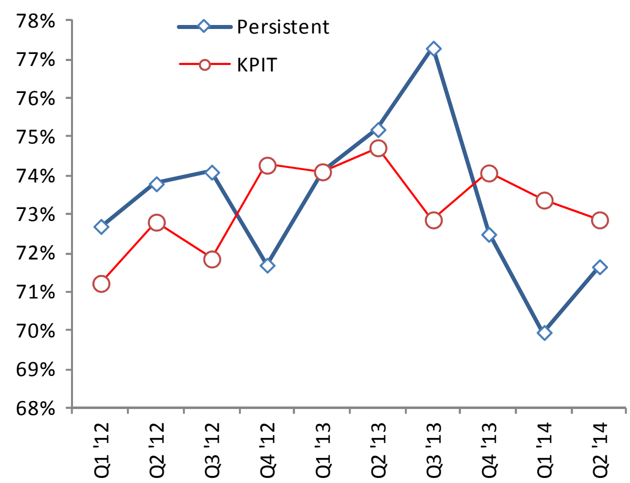
Q2FY14 review – IT Midcaps

	Actual			Consensus		
	Q2FY14	Q1FY14	QoQ	Q2FY14E	Deviation	Comments
Persistent Systems						
$ revenues	**68.5**	**63**	**8.6%**	**65.5**	**4.6%**	Strong $ revenue growth – ahead of expectations. IP led revenues grew by 38% QoQ, contributing to 19% of total revenues.
INR revenues	4,324	3,573	21.0%	4,114	5.1%	
EBITDA	**1,122**	**777**	**44.4%**	**980**	**14.5%**	EBITDA margins were supported by rupee depreciation (+270bps) and operational efficiencies (+450bps), which mitigated the impact of wage hikes (-310bps)
EBITDA margins	26.0%	21.7%	421bps	23.8%	213bps	
PAT	608	571	6.5%	571	6.5%	
EPS	**15.2**	**14.3**		**14.7**		PAT was impacted by FX loss of Rs100mn.
KPIT						
$ revenues	**112**	**109**	**3.1%**	**113**	**-0.9%**	$ rev growth fell short of expectations. Volumes grew by only 2.04% QoQ.
INR revenues	7,028	6,132	14.6%	7,025	0.0%	
EBITDA	1,088	972	11.9%	1,270	-14.3%	Margins were impacted by one time charges on additional hiring and training (-164bps), and non recurring provision for a delayed ERP project (-171bps), despite a positive impact of 250bps from INR depreciation.
EBITDA margins	**15.5%**	**15.9%**	**-37bps**	**18.1%**	**-260bps**	
PAT	667	601	11.0%	693	-3.7%	
EPS	**3.4**	**3.0**		**4.0**		

Source: Company, PhillipCapital India Research Estimates

S&M spends as a % of sales

Utilizations (blended)



Source: Company, PhillipCapital India Research Estimates

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