

IT

Multiple triggers to 'BUY'

India Equity Research | IT

IT stocks have corrected sharply over the past couple of months led by an appreciating INR and portfolio shifts. We strongly recommend buying into IT companies at this juncture due to: (i) limited impact of INR appreciation (1.5-3.0%), which can be offset by robust domestic demand and a few concrete initiatives by the new government (restoration of STPI status, uniform taxes and improved relations with the US); (ii) lower multiples, almost close to historic lows of post Lehman crisis (refer table 2 and 3), in an improving demand environment; and (iii) huge cash balances that can be returned to shareholders via dividends or buy back, thereby improving RoE. We reiterate 'BUY' on Infosys, Tata Consultancy Services (TCS), HCL Technologies (HCLT) and Tech Mahindra (TECHM) with target prices of INR4,307, INR2,538, INR1,591 and INR2,229, respectively.

Currency impact limited; can be offset via multiple external levers

Our calculations indicate that every 100bps of INR appreciation will impact margins 30-40bps and earnings 1.5-3.0%, which in our view can be largely offset by a few corrective measures by the new government: (a) restoration of STPI benefits; (2) relief from applicability of both service tax and VAT on software licences; and (3) higher domestic demand. We believe, these initiatives will not only enhance earnings of IT companies by 2%, but will also smoothen execution.

Low multiples, robust demand limit downside

Over the past couple of months, IT stocks have corrected sharply and multiples are close to historic lows of post Lehman era (low single digit). However, current demand, contrary to FY09, is on a firm footing riding US recovery and spurt in new technologies. Hence, in our view, chances of further multiple de-rating are limited and the impact of INR appreciation will be limited to 1.5-3.0%.

Huge cash piles can be returned to shareholders to improve RoE

Our analysis (refer table 4) indicates that the gap between RoEs and ex-cash RoEs of both Infosys and TCS is huge. This issue can be addressed by returning cash to shareholders either via special dividends or through buy backs. According to our analysis, if the above measures are taken, RoEs of both the companies will jump significantly.

Outlook: Low multiples, high demand infuse confidence

We believe a lot of pessimism has been built into current valuations of IT stocks, largely owing to the unfavourable currency despite strong demand. The currency impact can be offset by a combination of operational levers and policy initiatives, and hence we recommend buying into Infosys, TCS, HCLT and TECHM at this juncture. We reiterate our 'BUY' recommendation on Infosys, TCS, HCLT and TECHM with target prices of INR4,307, INR2,538, INR1,591 and INR2,229, respectively.

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Robust demand and policy initiatives to offset currency pain

Although most IT companies are adequately hedged for the next 6-12 months at an average INR/USD of 60 and above, we believe that FY15E and FY16E earnings of large cap companies could be impacted in the 1.5-3.0% range for every 100bps currency appreciation. We believe this can be offset by robust domestic demand and a few concrete initiatives by the new government (enumerated on page 1).

Table 1: Impact of currency on EPS and target prices

Currency Impact	Infosys			TCS			Wipro		
	FY15E	FY16E	TP on FY16	FY15E	FY16E	TP on FY16	FY15E	FY16E	TP on FY16
USD Revenues	9,263	10,435		15,795	18,331		7,441	8,397	
Net USD Receivables	3,705	4,174		6,318	7,332		2,976	3,359	
Net USD Receivables as % of total rev.	40.0	40.0		40.0	40.0		40.0	40.0	
EPS est. @ INR/USD 58/56 for FY15/16	226.8	250.2		111.4	132.7		36.0	39.8	
Hedging Policy	6 mths	6 mths		6 mths	6 mths		na	na	
Hedging Impact (%)	50.0	100.0		50.0	100.0		50.0	50.0	
Tax rate (%)	25.0	25.0		23.0	22.0		21.5	21.0	
Restated EPS & Target price									
54	212.2	228.3	4,110	104.0	121.0	2,421	33.2	37.7	565
55	214.6	233.8	4,209	105.2	124.0	2,479	33.6	38.2	573
56	217.0	239.3	4,307	106.5	126.9	2,538	34.1	38.8	581
57	219.5	244.8	4,406	107.7	129.8	2,596	34.6	39.3	590
58	221.9	250.2	4,504	108.9	132.7	2,654	35.1	39.8	598
59	224.3	255.7	4,603	110.2	135.6	2,713	35.5	40.4	606
60	226.8	261.2	4,702	111.4	138.6	2,771	36.0	40.9	614
61	229.2	266.7	4,800	112.7	141.5	2,830	36.5	41.5	622
62	231.6	272.2	4,899	113.9	144.4	2,888	37.0	42.0	630
63	234.0	277.6	4,997	115.2	147.3	2,947	37.4	42.5	638

Currency Impact	HCL Tech			Tech Mahindra		
	FY15E	FY16E	TP on FY16	FY15E	FY16E	TP on FY16
USD Revenues	6,158	7,087		3,513	3,995	
Net USD Receivables	2,463	2,835		1,405	1,598	
Net USD Receivables as % of total rev.	40.0	40.0		40.0	40.0	
EPS est. @ INR/USD 58/56 for FY15/16	94.7	104.1		131.3	147.1	
Hedging Policy	na	na		na	na	
Hedging Impact (%)	50.0	75.0		50.0	75.0	
Tax rate (%)	23.0	23.0		25.0	25.0	
Restated EPS & Target price						
54	86.7	94.8	1,517	117.7	131.6	2,105
55	88.0	97.1	1,554	119.9	135.4	2,167
56	89.4	99.5	1,591	122.2	139.3	2,229
57	90.7	101.8	1,628	124.5	143.2	2,291
58	92.0	104.1	1,665	126.8	147.1	2,353
59	93.4	106.4	1,702	129.0	150.9	2,415
60	94.7	108.7	1,739	131.3	154.8	2,477
61	96.1	111.0	1,776	133.6	158.7	2,539
62	97.4	113.3	1,813	135.8	162.6	2,601
63	98.8	115.6	1,850	138.1	166.4	2,663

Source: Edelweiss research

Low multiples not justified in a robust demand environment

Large-cap IT stocks have not traded below 10-13x one year forward earnings even in a flat to low single digit growth outlook. Hence, current low valuations do not justify the demand outlook. **We do not expect companies to test low multiples of FY09 as the demand scenario then was uncertain due to the Lehman crisis.**

Table 2: FY09 saw lowest multiples due to Lehman crisis anticipating lower demand in FY10

	Infosys		TCS		Wipro		HCLT	
	One year forward P/E	Revenue growth	One year forward P/E	Revenue growth	One year forward P/E	Revenue growth	One year forward P/E	Revenue growth
FY08	17.9	35.1	16.4	35.5	15.3	48.3	13.0	34.7
FY09	12.9	11.7	10.2	6.8	10.2	18.5	7.6	16.9
FY10	18.2	3.0	15.9	5.4	14.9	1.5	13.2	23.6
FY11	20.6	25.7	20.0	29.1	15.6	18.9	14.7	31.1
FY12	17.3	15.8	18.6	24.2	13.7	13.4	13.2	17.1
FY13	14.4	5.8	14.4	13.7	14.4	5.0	14.4	12.9
FY14	15.8	11.5	19.2	16.2	14.5	6.4	13.8	14.2

Source: Companies, Bloomberg

Table 3: Consensus multiples

	Consensus EPS (INR)			P/E (x)	
	FY15E	FY16E	CMP (INR)	FY15E	FY16E
TCS	111.1	127.7	2,190	19.7	17.1
Infosys	206.7	234.1	3,210	15.5	13.7
Wipro	35.9	40.2	530	14.8	13.2
HCLT	99.6	111.5	1,395	14.0	12.5
TechM	138.6	158.1	2,033	14.7	12.9

Source: Bloomberg

Cash utilisation could drive RoEs

Our analysis (refer table 4) indicates that the gap between RoEs and ex-cash RoEs of both Infosys and TCS is huge. This issue can be addressed by returning cash to shareholders either via special dividends or through buy backs. According to our analysis, if the above measures are taken, RoEs of both the companies will jump significantly.

Table 4: High cash impacting ROEs

	FY11	FY12	FY13	FY14
Infosys				
ROE (%)	25.0	27.4	25.7	24.4
Ex- cash ROE (%)	61.6	60.6	54.3	52.7
TCS				
ROE (%)	34.2	36.7	37.9	39.7
Ex- cash ROE (%)	52.0	54.0	56.7	66.0

Source: Companies, Edelweiss research

Table 5: Impact of buy back on Infosys

Infosys	FY15E	FY16E
Revenues (INR mn)	537,255	584,345
EBITDA (INR mn)	154,080	160,117
Other income (INR mn) (A)	30,063	37,633
PAT (INR mn)	126,715	136,681
EPS (INR)	221.8	239.2
Share count (mn)	575	575
Cash balance (INR mn)	362,452	427,114
ROE (%)	25.0	23.8
Offer price for buy back(INR)	3,600	3,800
Buy back of shares(10%)	58	58
Amount spent on buyback (INR mn)	207,000	218,500
Cash balance post buy back (INR mn)	155,452	208,614
Interest foregone due to buyback (INR mn) at 9% (B)	18,630	19,665
Reduced other income(INR mn) (A - B)	11,433	17,968
Other income ex -tax (INR mn)	8,003	12,578
Revised PAT (INR mn)	118,712	124,103
Revised EPS (INR)	229.4	239.8

Source: Edelweiss research

Table 6: Impact of buy back on TCS

TCS	FY15E	FY16E
Revenues (INR mn)	916,084	1,026,523
EBITDA (INR mn)	273,442	299,831
Other income (INR mn) (A)	18,919	34,396
PAT (INR mn)	213,163	248,209
EPS (INR)	108.9	126.8
Share count (mn)	1,957	1,957
Cash balance (INR mn)	351,367	462,040
ROE (%)	25.0	23.8
Offer price for buy back(INR)	2,400	2,600
Buy back of shares (5%)	98	98
Amount spent on buyback (INR mn)	234,867	254,439
Cash balance post buy back (INR mn)	116,501	207,601
Interest foregone due to buyback (INR mn)	21,138	22,899
Interest foregone post tax (INR mn)	14,797	16,030
Revised PAT (INR mn)	198,367	232,179
Revised EPS (INR)	106.7	124.9

Source: Edelweiss research

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Coverage group(s) of stocks by primary analyst(s): IT

CMC, eClerx Services, HCL Technologies, Hexaware Technologies, Infosys, Info Edge, Cyient, Persistent Systems, Tata Consultancy Services, Tech Mahindra, Wipro

Recent Research

Date	Company	Title	Price (INR)	Recos
10-Jun-14	Mindtree	Tracing the growth map; <i>Company Update</i>	791	Not Rated
28-May-14	Infosys	Another exit; another setback; EdelFlash	3,173	Buy
21-May-14	IT	Low multiples, high demand, effective govt: Growth harbingers; <i>Sector Update</i>		

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	133	40	16	190
* 1 stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	126	55	9	

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

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