

India Research

Information Technology

SECTOR UPDATE

Currency Headwinds To Restrict Near Term Upside

Currency headwinds will adversely impact Indian IT firms' reported USD numbers in 4QFY15 and FY16. The USD has strengthened considerably against key currencies like the EUR, GBP and AUD given improving US economic data and likelihood of the US Federal Reserve increasing rates later this year. We expect 320bps-600bps impact on IT firms' USD revenue growth in FY16 owing to USD strength, even as volume growth estimates remain unchanged. We downgrade revenue/earnings by 1%-5% for FY16E/FY17E factoring in USD strength. We remain structurally positive on Indian IT given strong growth prospects and recommend accumulating on any decline. Our top picks are HCLT and Tech Mahindra in the large cap space, while we like Cyient in the mid cap space.

USD strength to adversely impact FY16 revenue growth: The USD has gained 10% against the EUR, 4% against the GBP and 8% against the AUD this QTD (quarterly average), while over the past year, the appreciation has been 20%, 7% and 18%, respectively. The INR has also appreciated against these currencies, but not depreciated significantly against the USD. We lower FY16E/FY17E revenue estimates for all IT firms under our coverage by 1%-5%. Hexaware is expected to see maximum impact of over 600bps on revenue growth as it will feel the effect in CY15 itself (December-ending FY). Cyient will see over 530bps impact in FY16 owing to its higher exposure to these currencies. HCLT will witness the least impact of 350bps as it has a June-ending FY. **Top-tier IT firms will lose US\$188mn-US\$680mn in revenue, while mid-sized IT firms will lose US\$25mn-US\$30mn in revenue in FY16 on account of USD appreciation against the EUR, GBP and AUD.**

Volume growth to remain healthy: We do not expect changes in our volume growth estimates at this point. Given improving growth in the US market, sustained demand strength in Europe led by RTB services and expansion of services in newer geographies like the Middle East and South East Asia, we expect demand growth to remain robust for IT firms over FY15E-FY17E.

Near-term headwinds not an industry-wide trend: There have been cautious comments by some companies regarding the near-term growth outlook. TCS has said that initial growth momentum is turning out to be slightly slower than what they had anticipated, Mindtree has downgraded growth outlook for 4QFY15, Persistent Systems has given a cautious outlook on client-specific issues, and KPIT Technologies has indicated a muted March 2015 quarter. In our view, these issues are transitory in nature regards TCS, while the other instances are owing to client-specific factors rather than industry-wide issues.

Downgrade revenue, earnings 1%-5%, remain structurally positive: Owing to the adverse cross-currency movements, we downgrade our USD revenue estimates by 1%-4% assuming that currency rates will sustain at these levels. We also downgrade EPS estimates by 1%-5% for the IT firms under our coverage. Thus, we reduce our target prices by similar amounts. **We remain structurally positive on the IT sector. Our preferred picks in the top-tier IT space are HCLT and Tech Mahindra, while in the mid cap space we like Cyient and would advise accumulating on any dips.**

Tata Consultancy Services	Hold
CMP (Rs)	2,594
Target price (Rs)	2,739
Previous target price (Rs)	2,830
Upside	6%
Infosys	Hold
CMP (Rs)	2,230
Target price (Rs)	2,362
Previous target price (Rs)	2,390
Upside	6%
Wipro	Hold
CMP (Rs)	633
Target price (Rs)	657
Previous target price (Rs)	670
Upside	4%
HCL Technologies	Hold
CMP (Rs)	979
Target price (Rs)	1,050
Previous target price (Rs)	1,095
Upside	7%
Tech Mahindra	Buy
CMP (Rs)	686
Target price (Rs)	779
Previous target price (Rs)	800
Upside	14%
Mindtree	Sell
CMP (Rs)	1,401
Target price (Rs)	1,159
Previous target price (Rs)	1,250
Downside	17%
Cyient	Hold
CMP (Rs)	544
Target price (Rs)	598
Previous target price (Rs)	620
Upside	10%
Hexaware Technologies	Sell
CMP (Rs)	274
Target price (Rs)	190
Previous target price (Rs)	197
Downside	31%

Analysts Contact

Harit Shah

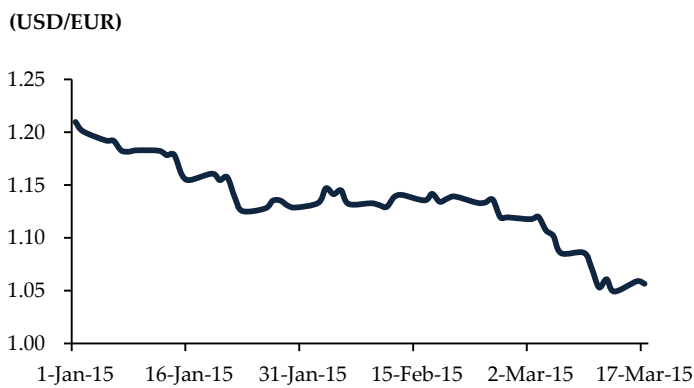
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USD strength to adversely impact FY16 USD growth

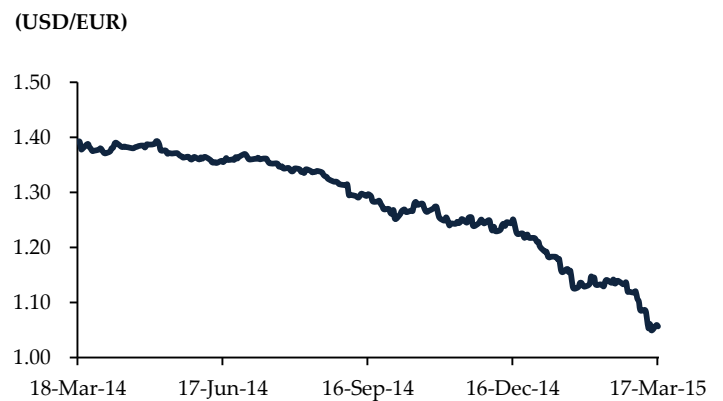
Over the past few weeks, the USD has strengthened significantly against most major global currencies including the EUR, GBP and AUD, key currencies for Indian IT firms accounting for 25%-30% of their billings. **The USD has gained 10% against the EUR, 4% against the GBP and 8% against the AUD this QTD, based on the quarterly average, while over the past year, the appreciation has been to the tune of 20%, 7% and 18%, respectively.** Key factors driving this strong appreciation have been improving US GDP growth, multi-year low unemployment rates and the likelihood of the US Federal Reserve hiking rates sometime later this year given improving macro-economic data, which could lead to global fund flows into US assets, thus triggering fund outflows from emerging markets like India and further strengthening the USD.

Exhibit 1: USD vs EUR QYD



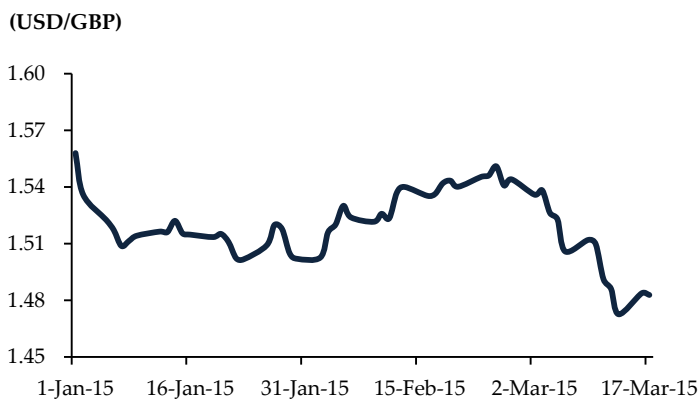
Source: Bloomberg, Karvy Stock Broking

Exhibit 2: USD vs EUR – One year movement



Source: Bloomberg, Karvy Stock Broking

Exhibit 3: USD vs GBP QTD



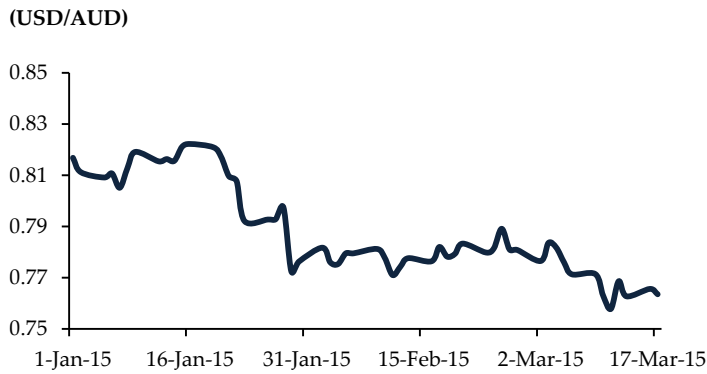
Source: Bloomberg, Karvy Stock Broking

Exhibit 4: USD vs GBP – One year movement



Source: Bloomberg, Karvy Stock Broking

Exhibit 5: USD vs AUD QTD



Source: Bloomberg, Karvy Stock Broking

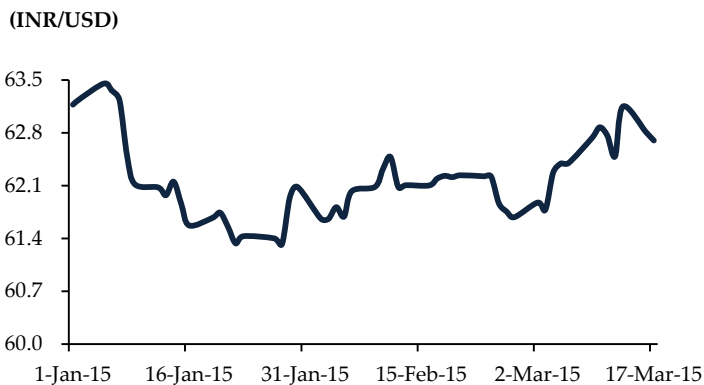
Exhibit 6: USD vs AUD – One year movement



Source: Bloomberg, Karvy Stock Broking

The USD has appreciated significantly against emerging market currencies, hitting an over 13-year high against the South African Rand and a 17-year high against the Indonesian Rupiah. However, interestingly the INR has not depreciated that significantly of late against the USD compared with other global currencies, aided by factors such as favourable fund flows, an expected improvement in India’s GDP growth under the NDA government and lower inflation. **The USD has gained 0.3% against the INR QTD, while over the past year also the appreciation has been to the tune of 0.3%.**

Exhibit 7: INR vs USD QTD



Source: Bloomberg, Karvy Stock Broking

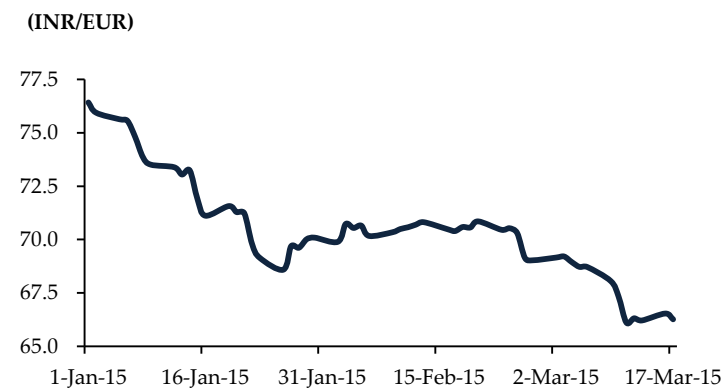
Exhibit 8: INR vs USD – One year movement



Source: Bloomberg, Karvy Stock Broking

Apart from this, **the INR has also appreciated against the EUR, GBP and AUD, by 9%, 4% and 7%, respectively QTD and 17%, 6% and 15%, respectively over the past year.** This is likely to hit INR revenue growth for IT firms, which is likely to come in lower than USD revenue growth in 4QFY15 and most likely in FY16 as well, given that the impact will be witnessed for the full fiscal year.

Exhibit 9: INR vs EUR QTD



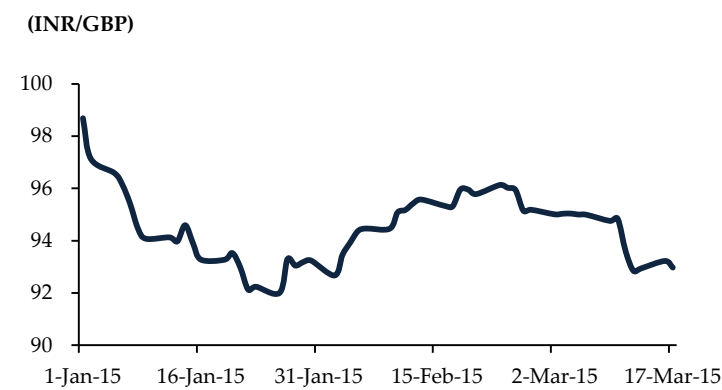
Source: Bloomberg, Karvy Stock Broking

Exhibit 10: INR vs EUR – One year movement



Source: Bloomberg, Karvy Stock Broking

Exhibit 11: INR vs GBP QTD



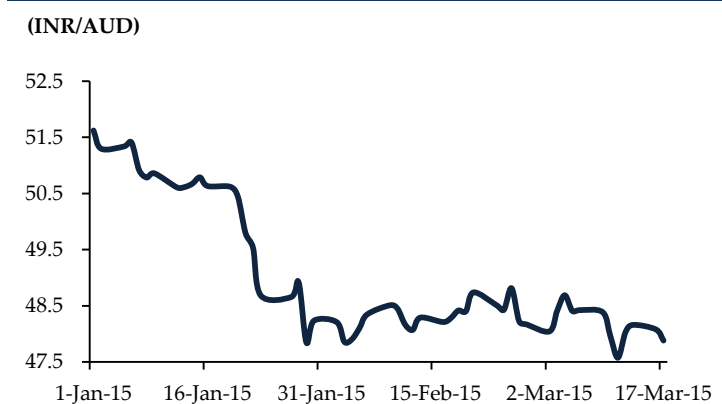
Source: Bloomberg, Karvy Stock Broking

Exhibit 12: INR vs GBP – One year movement



Source: Bloomberg, Karvy Stock Broking

Exhibit 13: INR vs AUD QTD



Source: Bloomberg, Karvy Stock Broking

Exhibit 14: INR vs AUD – One year movement



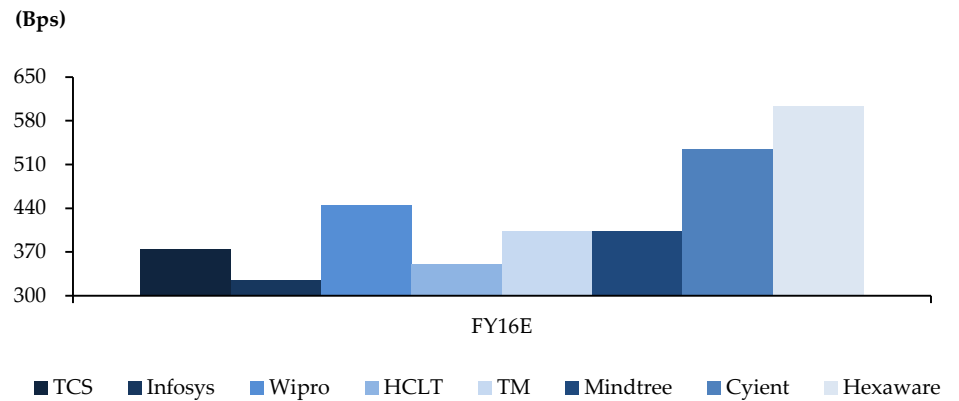
Source: Bloomberg, Karvy Stock Broking

These currency movements will result in a double-whammy for IT companies. On one hand, reported USD revenue will take a hit, given that 25%-30% of their billings are in EUR, GBP and AUD. On the other hand, there will not be a proportionate benefit in INR terms given the much lower depreciation of the local currency compared with the USD. Add to that, INR appreciation against cross-currencies will result in a hit to reported INR numbers as well, leading to INR

revenue growth even trailing USD revenue growth. This is likely to happen in 4QFY15 and could be a trend in FY16.

We lower FY16E/FY17E revenue estimates for all IT firms under our coverage after factoring in adverse cross-currency impact for 4QFY15 and for FY16. Hexaware is expected to witness the maximum impact of over 600bps as it will feel the full effect in CY15 itself (December-ending fiscal year). Cyient is likely to see over 530bps impact in FY16 owing to its relatively higher exposure to these currencies, followed by Wipro and Tech Mahindra. HCLT is likely to witness the least impact of 350bps owing to the fact that its financial year ends in June. TCS and Infosys will see 374bps and 324bps impact, respectively.

Exhibit 15: Impact on USD revenue growth in FY16



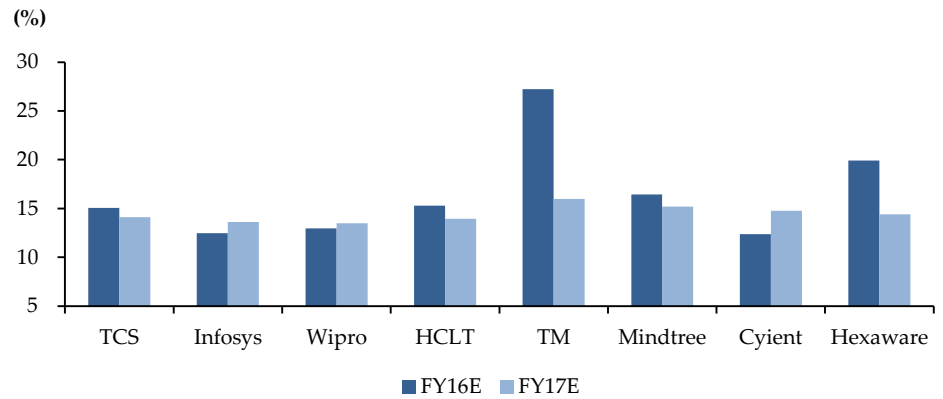
Source: Bloomberg, Respective companies, Karvy Stock Broking;

Note: We have taken CY15E impact for Hexaware, as it has a December-ending fiscal year.

Volume growth to remain healthy, demand solid

While currency headwinds could pressurise near-term stock performance, we do not expect any major change in our volume growth and core business growth estimates at this point. Given improving growth in the key US market, sustained demand strength in Europe led by RTB services and expansion of services in newer geographies like the Middle East and South East Asia, we expect demand growth to remain robust for IT firms over FY15E-FY17E. We expect 11%-16% YoY organic volume growth over the period for the top-tier IT firms, with Tech Mahindra, TCS and HCLT likely to trend near the upper end of the range, while Infosys and Wipro are likely to come in closer to the lower end. For mid-sized IT firms also, we expect a similar 12%-16% organic volume growth range. Owing to adverse cross-currency movements, reported USD revenue growth is likely to come in lower than volume growth.

Exhibit 16: Volume growth – Remaining healthy



Source: Respective companies, Karvy Stock Broking

Near-term headwinds not an industry trend

There have been recent cautious comments by some companies regarding the near-term growth outlook for the IT sector. Industry bellwether, TCS has said that the initial growth momentum in IT budgets is turning out to be slightly slower than what they had initially anticipated. Mindtree has effectively downgraded its growth outlook for 4QFY15 to flattish organic CC revenue, owing to delay in project starts at a couple of retail & CPG clients. Persistent Systems has also given a cautious outlook for the quarter owing to client-specific issues, while KPIT Technologies has also indicated a muted March 2015 quarter. All the companies have mentioned the major impact that adverse cross-currency headwinds are likely to have on their reported USD revenue growth going forward.

In our view, these issues are largely transitory in nature regards TCS, while the other instances are more owing to client-specific factors than any industry-wide issues. It should be noted that CC revenue growth in 4QFY15 for TCS is largely expected to be in-line with 4Q growth of earlier years. Thus, this is an indication that there has been no downgrade in terms of core business growth expectations. In any case, 4Q tends to be a slow quarter, given that from the client perspective, IT budgets tends to be finalised in this quarter (1Q of the calendar year for them) and as a result, there tends to be initially low activity on this front at the beginning of the quarter. Mindtree and Persistent are facing client-specific issues. Cross-currency impact is a common thread across IT firms and we also expect this factor to affect all the other IT firms under our coverage. Thus, from a CC growth perspective, at this point we are not downgrading our estimates.

Downgrade revenue, earnings 1%-5%, target prices down similarly, remain structurally positive

Owing to the adverse cross-currency movements and the USD strength against all major currencies, we are downgrading our USD revenue estimates by 1%-4%. This is assuming that currency rates will sustain at these levels going forward. We also downgrade EPS estimates by 1%-5% for the IT firms under our coverage. Thus, we reduce our target prices by similar amounts. **We remain structurally positive on the IT sector given strong growth prospects on account of an improving US economy, sustained strength in Europe led by RTB services, newer growth opportunities through geographic expansion into countries like Japan and the**

Middle East, and incremental growth opportunities in the digital space. Our preferred picks in the top-tier IT space are HCLT and Tech Mahindra, while in the mid cap space we like Cyient and would advise accumulating on any dips.

Exhibit 17: Changes in estimates - TCS

TCS	Earlier estimates	Revised estimates	% change
FY16E			
Revenue (US\$mn)	17,540	17,438	(0.6)
Revenue (Rsmn)	1,069,919	1,063,705	(0.6)
EBITDA (Rsmn)	315,483	307,408	(2.6)
EBITDA margin (%)	29.5	28.9	(59)bps
EPS (Rs)	125.2	122.1	(2.5)
FY17E			
Revenue (US\$mn)	19,895	19,715	(0.9)
Revenue (Rsmn)	1,193,697	1,182,921	(0.9)
EBITDA (Rsmn)	355,844	350,899	(1.4)
EBITDA margin (%)	29.8	29.7	(15)bps
EPS (Rs)	138.8	136.9	(1.3)

Source: Karvy Stock Broking

Exhibit 18: Change in estimates - Infosys

Infosys	Earlier estimates	Revised estimates	% change
FY16E			
Revenue (US\$mn)	9,769	9,594	(1.8)
Revenue (Rsmn)	595,919	585,216	(1.8)
EBITDA (Rsmn)	169,889	165,505	(2.6)
EBITDA margin (%)	28.5	28.3	(23)bps
EPS (Rs)	122.2	119.2	(2.5)
FY17E			
Revenue (US\$mn)	11,098	10,899	(1.8)
Revenue (Rsmn)	665,877	653,953	(1.8)
EBITDA (Rsmn)	191,622	189,304	(1.2)
EBITDA margin (%)	28.8	28.9	17bps
EPS (Rs)	136.3	134.9	(1.0)

Source: Karvy Stock Broking

Exhibit 19: Change in estimates - Wipro

Wipro	Earlier estimates	Revised estimates	% change
FY16E			
IT service revenue (US\$mn)	7,971	7,726	(3.1)
IT service revenue (Rsmn)	486,208	471,285	(3.1)
Cons. EBITDA (Rsmn)	123,009	118,161	(3.9)
EBITDA margin (%)	25.3	25.1	(23)bps
EPS (Rs)	40.1	39.3	(2.2)
FY17E			
IT service revenue (US\$mn)	9,039	8,769	(3.0)
IT service revenue (Rsmn)	542,342	526,129	(3.0)
Cons. EBITDA (Rsmn)	139,040	133,951	(3.7)
EBITDA margin (%)	25.6	25.5	(18)bps
EPS (Rs)	44.8	43.8	(2.1)

Source: Karvy Stock Broking

Exhibit 20: Change in estimates – HCL Technologies

HCL Technologies	Earlier estimates	Revised estimates	% change
FY16E			
Revenue (US\$mn)	6,902	6,727	(2.5)
Revenue (Rsmn)	421,007	410,352	(2.5)
EBITDA (Rsmn)	103,381	99,326	(3.9)
EBITDA margin (%)	24.6	24.2	(35)bps
EPS (Rs)	59.9	57.3	(4.4)
FY17E			
Revenue (US\$mn)	7,839	7,666	(2.2)
Revenue (Rsmn)	470,369	459,976	(2.2)
EBITDA (Rsmn)	116,284	113,640	(2.3)
EBITDA margin (%)	24.7	24.7	(2)bps
EPS (Rs)	68.5	65.6	(4.2)

Source: Karvy Stock Broking

Exhibit 21: Change in estimates – Tech Mahindra

Tech Mahindra	Earlier estimates	Revised estimates	% change
FY16E			
Revenue (US\$mn)	4,664	4,469	(4.2)
Revenue (Rsmn)	284,506	272,608	(4.2)
EBITDA (Rsmn)	57,498	53,514	(6.9)
<i>EBITDA margin (%)</i>	20.2	19.6	(58)bps
EPS (Rs)	40.4	39.8	(1.4)
FY17E			
Revenue (US\$mn)	5,420	5,183	(4.4)
Revenue (Rsmn)	325,193	311,005	(4.4)
EBITDA (Rsmn)	66,704	62,335	(6.5)
<i>EBITDA margin (%)</i>	20.5	20.0	(47)bps
EPS (Rs)	47.0	45.8	(2.5)

Source: Karvy Stock Broking

Exhibit 22: Change in estimates – Mindtree

Mindtree	Earlier estimates	Revised estimates	% change
FY16E			
Revenue (US\$mn)	673	656	(2.5)
Revenue (Rsmn)	41,066	40,040	(2.5)
EBITDA (Rsmn)	8,302	7,966	(4.0)
<i>EBITDA margin (%)</i>	20.2	19.9	(32)bps
EPS (Rs)	75.4	72.8	(3.5)
FY17E			
Revenue (US\$mn)	767	756	(1.5)
Revenue (Rsmn)	46,041	45,368	(1.5)
EBITDA (Rsmn)	9,439	9,162	(2.9)
<i>EBITDA margin (%)</i>	20.5	20.2	(31)bps
EPS (Rs)	85.3	82.8	(2.9)

Source: Karvy Stock Broking

Exhibit 23: Change in estimates – Cyient

Cyient	Earlier estimates	Revised estimates	% change
FY16E			
Revenue (US\$m)	560	541	(3.4)
Revenue (Rsmn)	34,171	33,006	(3.4)
EBITDA (Rsmn)	5,635	5,293	(6.1)
<i>EBITDA margin (%)</i>	16.5	16.0	(45)bps
EPS (Rs)	37.9	36.3	(4.1)
FY17E			
Revenue (US\$m)	640	628	(1.8)
Revenue (Rsmn)	38,372	37,676	(1.8)
EBITDA (Rsmn)	6,715	6,416	(4.5)
<i>EBITDA margin (%)</i>	17.5	17.0	(47)bps
EPS (Rs)	46.4	45.0	(3.0)

Source: Karvy Stock Broking

Exhibit 24: Change in estimates – Hexaware

Hexaware Technologies	Earlier estimates	Revised estimates	% change
CY15E			
Revenue (US\$m)	498	481	(3.3)
Revenue (Rsmn)	30,352	29,345	(3.3)
EBITDA (Rsmn)	5,822	5,587	(4.0)
<i>EBITDA margin (%)</i>	19.2	19.0	(14)bps
EPS (Rs)	13.0	12.4	(4.6)
CY16E			
Revenue (US\$m)	566	550	(2.7)
Revenue (Rsmn)	33,934	33,022	(2.7)
EBITDA (Rsmn)	6,555	6,276	(4.3)
<i>EBITDA margin (%)</i>	19.3	19.0	(31)bps
EPS (Rs)	15.1	14.5	(4.0)

Source: Karvy Stock Broking

Exhibit 25: Valuation Matrix

Company	Rating	CMP	TP	Up/ (Down)	Revenue (Rs mn)			EBITDA (Rs mn)			EPS (Rs)			P/E (x)			EV/EBITDA (x)		
					Rs	Rs	%	FY15E	FY16E	FY17E	FY15E	FY16E	FY17E	FY15E	FY16E	FY17E	FY15E	FY16E	FY17E
TCS	Hold	2,594	2,739	6	947,267	1,063,705	1,182,921	269,852	307,408	350,899	107	122	137	24	21	19	18	16	14
Infosys	Hold	2,230	2,362	6	536,284	5,85,216	653,953	150,060	165,505	189,304	109	119	135	21	19	17	15	13	11
Wipro	Hold	633	657	4	466,563	505,132	563,349	106,917	118,161	133,951	36	39	44	18	16	14	13	11	10
HCLT	Hold	979	1,050	7	367,081	410,352	459,976	92,162	99,326	113,640	53	57	66	19	17	15	13	12	10
TM	Buy	686	779	14	221,919	272,608	311,005	42,533	53,514	62,335	29	40	46	23	17	15	15	12	10
Mindtree	Sell	1,401	1,159	(17)	35,457	40,040	45,368	7,142	7,966	9,162	65	73	83	22	19	17	15	13	12
Cyient	Hold	544	598	10	27,017	33,006	37,676	4,196	5,293	6,416	31	36	45	18	15	12	12	11	9
HTL	Sell	274	190	(31)	25,817	29,345	33,022	4,776	5,587	6,276	11	12	15	26	22	19	17	14	12

Source: Karvy Stock Broking

Stock Ratings	Absolute Returns
Buy	> 15%
Hold	5-15%
Sell	< 5%

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Disclosures Appendix

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