

## India's Outsourcing Companies Hit a Soft Spot

By Leslie P. Norton

Shares of India's big information-technology companies swung wildly last week as their results for the fiscal fourth quarter, ended March, raised concern that demand for IT outsourcing may be slowing. The stocks recovered by the week's end, but with an expected spate of additional stock offerings under way, they might tread water for months.

Signs of a softer environment emerged as the companies reported fourth-quarter earnings. Tata Consultancy Services and Infosys Technologies (ticker: INFY), India's two largest IT outsourcers, disappointed investors. TCS dramatically missed earnings for the quarter, owing to higher wage expenses and the rupee's strength. Infosys said that revenue in the current quarter would be flat because of a temporary drop in US business stemming from Sarbanes-Oxley requirements.

That statement dragged shares of the outsourcers lower. But by the end of the week, they started to recover, as Satyam Computer Services (SAY), the fourth-largest outsourcer, said net profit jumped 54% for the quarter and 39% for the full year, though it warned that profit margins might slip in the current year. Wipro (WIT), India's third-largest IT outsourcer, reported that earnings had risen 38% in the quarter, in line with expectations, and issued a surprise one-for-one bonus share issue.

Thus, Infosys' American depository shares ended the week at 63 and change, higher on the week and up 44% from its level a year ago. Wipro's American depository receipts closed at 19, up 20% in the past 12 months; Satyam, at 22.81, is up 7%. Last week's results also pointed up that investors are making radical distinctions between the companies in the sector. TCS, which doesn't have an ADR, closed at 1,166 Indian rupees (\$26.66), down sharply on the week. Still, it's up 37% from its price at its August initial public offering.

India's IT outsourcers have hit road bumps before, on dollar weakness and concern that wage rates and employee turnover were rising too quickly. Today, the challenge is to maintain high rates of growth when the companies are expanding from such a large base. It's widely agreed that the days of 100% earnings increases are past, but what a sustainable growth rate might be is a matter of some debate. The outsourcing plays are still gaining ground against companies like EDS, and are trying to maintain their cost advantage by opening facilities where wage rates are even lower. They're also trying to mount revenue-boosting initiatives such as winning consulting contracts. Last week, for example, Satyam unveiled plans to buy Citisoft, a UK consulting firm with annual revenue of \$16.5 million, for \$39.3 million.

"The issue isn't whether offshoring is coming to an end, but do we really understand the predictability of the business," said Ashish Thadhani, an analyst at Gilford Securities. "Some of the valuation tailwinds are not at your back, so some of the near term upside is not likely to materialize. But as you get into the back half of the year, you'll see a resumption of momentum."

Arjun Divecha, manager of GMO Emerging Markets Fund, owns shares of both Infosys and TCS, but he concedes that smaller outsourcing plays offer better value and potential returns. At the bigger companies, "earnings growth is still decent, but it's being priced in," he says.

**That's an understatement to some including Jon Thorn, who runs India Capital, a top-performing India-focused hedge fund. "The valuations have gotten ahead of themselves," says Thorn, and even after last week, the stocks "are still too expensive" and are forecasting "impossibly achievable earnings."**

**Infosys trades at 30 times earnings, about on a par with its long-term growth rate. Wipro, on the other hand, changes hands at 38 times earnings, even though its long-term growth rate is about 30%. "The valuation premium should come down to what they're doing in earnings," Thorn reckons.**

Yet growth rates remain sufficiently stunning for many investors to stay in the shares. "They're still interesting, and the pipeline is still strong," says Richard Parower, manager of Seligman Global Technology mutual fund, who likes Infosys and Tata.

Rukhshad Shroff of JP Morgan Investment Management pointed out that Infosys has a history of sandbagging investors with conservative estimates. "Exactly 12 months ago," Shroff relates, "Infosys gave guidance that it expected earning growth of 24%. And growth was 47%." He thinks Infosys will revise estimates of its own growth higher each quarter. Infosys chief Nandan Nilekani said the company might raise its earning outlook as growth prospects improve.

What is certainly true is that Infosys and Satyam are planning to issue more shares in the US in secondary offerings in coming months. The move would improve liquidity and branding for the outsourcers, but he added supply certainly would weigh on stock prices.

"None of these stocks are cheap, and they could all adjust by 8-10% lower," says Shroff of JP Morgan. Still he's a fan of Infosys.

Ashish Thadhani of Gilford thinks a premium to the growth rate is still deserved. He's maintaining his estimates for Infosys, though he points out that revenue growth for the fiscal 1st quarter is likely to be subdued. Infosys should offset that with cost cuts. And after the 1st quarter, growth ought to snap back, the analyst said. Thadhani trimmed his price target for Infosys to \$81 on the ADS, or 35 times earnings. His price target for Wipro is \$27.

"Broadly speaking, the offshoring trend is intact," says Shroff of JP Morgan. "These are reasonable growth rates for companies" with thousand of employees and billions of dollars in revenue, he says. And if times grow hard, as they often do, corporate America will cut back again and seek to improve returns by using low-cost suppliers. That can only be good news for India's outsourcers.