

In an uncharted territory

- A guidance miss, due to what we believe are 'exceptional' budget delays at key clients (revenues from 5 of the top-10 clients fell ~7% QoQ) and a worse-than-expected margin fall (300bps YoY) in its FY12 guidance, were key negative surprises in Infosys' 4QFY11 results.
- The timing of Mohandas Pai's exit is also arguably abrupt, especially with the leadership changes happening in another fortnight.
- Would the peers, TCS and Wipro share a similar fate in 4QFY11? We believe the contrary and expect them to deliver revenue growth 3-4pps ahead of Infosys, with operating margins being flat QoQ.
- While Infosys has corrected by ~10% post results, given the likely earnings downgrades by ~8-10%, valuations haven't de-rated. Given the likely out-performance of peers and lack of any positive triggers over the near term, we think a de-rating is likely.
- On a weaker FY11 revenue exit rate and poor margin outlook, we are cutting our FY12ii EPS by ~10% to Rs137.5 and rating to ADD.

Result update

CMP	Rs2,990	Price performance (%)			
12-mth TP (Rs)	3,011 (1%)		1M	3M	1Y
Market cap (US\$ m)	38,493	Infosys	-1.3	-6.7	7.8
Bloomberg	INFO IN	Rel. to Sensex	-6.5	-9.5	-1.0
Sector	IT Services	Wipro	1.7	-2.9	3.8
		TCS	9.3	6.4	46.9
		HCL Tech	6.0	2.6	35.3
Shareholding pattern (%)		Stock performance			
Promoters	16.0	52Wk High/Low (Rs)	3,499/2,485		
FIIIs	36.6	Shares o/s (m)	574		
DIIIs	8.4	Daily volume (US\$ m)	81		
ADRs	18.3	Dividend yield FY11ii (%)	2.0		
		Free float (%)	84.0		

Financial summary (Rs m)

Y/e 31 Mar	1QFY10	2QFY10	3QFY10	4QFY10	1QFY11	2QFY11	3QFY11	4QFY11	1QFY12ii	FY10	FY11	FY12ii
Realizations (US\$/hour)	39	39	39	39	38	39	40	41	41	39	40	41
% growth (YoY)	-8.3	-7.6	-0.6	0.9	-1.7	1.0	1.6	5.8	7.5	-4.0	1.8	2.5
Volumes (man-months)	149,961	153,388	162,755	171,232	184,279	197,478	203,676	200,744	211,785	637,336	786,177	947,343
% growth (YoY)	6.0	1.8	5.9	13.0	22.9	28.7	25.1	17.2	14.9	6.7	23.4	20.5
Employee utilization	67.0%	67.3%	68.8%	69.3%	73.5%	75.2%	72.7%	67.7%	69.7%	65.7%	70.4%	70.5%
change (pps)	-0.6	0.3	1.5	0.5	4.2	1.7	-2.5	-5.0	2.0	-1.7	4.7	0.1
Revenues (Rs m)	54,720	55,850	57,410	59,440	61,980	69,470	71,060	72,500	75,589	227,396	275,010	331,601
% change	12.7	3.1	-0.8	5.5	13.3	24.4	23.8	22.0	22.0	4.8	20.9	20.6
EBITDA (Rs m)	18,680	19,330	20,380	20,200	19,600	23,130	23,620	23,210	22,337	78,566	89,560	102,700
EBITDA Margins (%)	34.1	34.6	35.5	34.0	31.6	33.3	33.2	32.0	29.6	34.6	32.6	31.0
Effective tax rate (%)	-20.3	-20.5	-22.3	-21.4	-25.4	-26.4	-26.9	-27.9	-26.0	-21.2	-26.8	-26.0
Reported PAT (Rs m)	15,270	15,400	15,820	16,150	14,880	17,476	17,818	18,100	17,153	62,386	68,140	78,623
PAT (Pre-Exceptional) (Rs m)	15,270	15,400	15,820	16,150	14,880	17,476	17,818	18,100	17,153	62,386	68,140	78,623
% change	17.3	7.5	-3.6	0.2	-2.6	13.5	12.6	12.1	15.3	4.8	9.2	15.4

Source: Company, IIFL Research. Priced as on 15 April 2011

Guidance miss:

Infosys's 4QFY11 revenues at US\$1,602m were marginally below even the low end of its guidance (US\$1,606m). A surprising de-growth in volumes due to likely delay in budget releases at key clients has led to the negative surprise. Almost all the growth engines de-grew during 4QFY11. Revenues from US, BFSI, Telecom and its high-end ERP/consulting business were down 0.5% to 5% QoQ.

Figure 1: Performance vs Guidance

US\$ m	4QFY11 guidance	4QFY11 guidance - adjusted for currency	Actual
Revenues	1,601 to 1,617	1,606 to 1,622	1,602

Source: Company, IIFL Research

Margin outlook remains encouraging:

Infosys, in our view, has amongst the best margin levers among larger IT vendors.

- It has hired ahead of its requirements. As such, its employee utilisation at ~67.5% is ~10pps lower than peers. Also, trainees are ~7.5% of billable employees.
- Pricing is up for the third quarter in a row. Management commentary on pricing has been encouraging, with it having registered both like-to-like and COLA price increases in 4QFY11. Going forward, the traditional superiority in pricing along with high exposure to discretionary ERP/consulting services gives it an advantage in securing pricing increases.

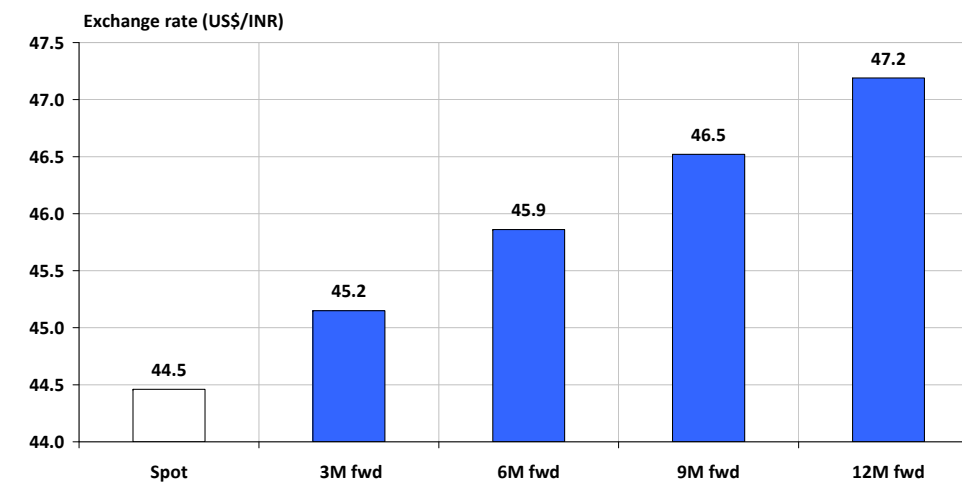
Conservative assumptions in FY12 guidance:

On 20% revenue growth (US\$, YoY) guidance for FY12, we believe the company's operating margin outlook of -300bps YoY is highly conservative. Potential upsides exist due to better volumes, pricing, exchange rate and even employee utilisation.

- Against the trend of better realisations over the past three quarters, the company assumed minimal pricing increases for FY12.

- Also, despite lower utilisations (75% ex-trainees vs optimal 78%), the guidance doesn't assume any significant tailwinds from them in FY12.
- While Infosys's guidance is based on its policy of quarter-end exchange rate (US\$/Rs: 44.5), 1-year forward contracts are ~6% above spot. Such a rate could add ~Rs4 to FY12 EPS.

Figure 2: 1-year forward rate on US\$/INR is ~6% above spot



Source: Company, IIFL Research

De-rating likely?

We expect TCS and Wipro to have ~3-4pps better revenue growth than Infosys and flat margins QoQ vs a margin fall of ~125bps at Infosys. Also, Infosys's current consensus EPS estimates are ~20% above its FY12 guidance and are likely to be revised downwards. While the stock has corrected ~10% after its results, post the likely earnings downgrades, its valuations (1-year forward P/E) are on-par with TCS and at a ~20% premium to Wipro. As such, we expect it to de-rate further.

Figure 3: 4QFY11 financial summary

Income stmt brief (Rs m)	4QFY10	3QFY11	4QFY11	QoQ	YoY
Net sales	59,440	71,060	72,500	2.0%	22.0%
Net Sales (US\$ m)	1,296	1,585	1,602	1.1%	23.6%
COGS	-31,840	-38,480	-40,150		
Gross profits	27,600	32,580	32,350	-0.7%	17.2%
Gross margins	46.4%	45.8%	44.6%		
S&M	-3,330	-3,930	-4,000		
G&A	-4,070	-5,030	-5,140		
EBITDA	20,200	23,620	23,210	-1.7%	14.9%
EBITDA margin	34.0%	33.2%	32.0%	-123 bps	-197 bps
Depreciation	-2,200	-2,150	-2,190		
Other income	1,980	2,900	4,150		
Exceptionals	480	0	0		
PBT	20,460	24,370	25,170	3.3%	23.0%
PBT margin	34.4%	34.3%	34.7%		
Tax	-4,410	-6,570	-6,990		
ETR	21.6%	27.0%	27.8%		
PAT	16,050	17,800	18,180	2.1%	13.3%
PAT margin	27.0%	25.0%	25.1%		
EPS	28.3	31.2	31.8		
Operating metrics					
Pricing - onsite (US\$/hr)	69.4	73.4	74.0	0.7%	6.5%
Pricing - offshore (US\$/hr)	26.4	26.0	27.0	3.6%	2.2%
Volumes - onsite (man months)	49,183	59,991	59,891	-0.2%	21.8%
Volume - offshore (man months)	122,049	143,685	140,853	-2.0%	15.4%
Onsite effort	28.7%	29.5%	29.8%	38 bps	111 bps
Fixed price	39.5%	41.2%	41.0%	-20 bps	150 bps
Utilization with trainees	69.3%	72.7%	67.7%	-500 bps	-160 bps
Total employees	113,796	127,779	130,820	2.4%	15.0%
Top client	4.6%	4.6%	4.7%	10 bps	10 bps

4QFY11 revenue guidance of US\$1,606m (low-end)

Despite an increase in realisations (3.6% onsite), EBITDA margins fell on a volume de-growth and low utilisations (-500bps QoQ)

Tax rates remain amongst the highest in the industry. Infosys has only ~20% of revenues from SEZ against peers' ~50% and is likely to have a tax rate of 26% to 27% for FY12

Unlike the pricing increases driven by better business mix in the past quarters, Infosys' had both like-to-like and 'cost of living adjustment' based price increases in 4QFY11

Employee utilisations are ~10pps below peers' utilisations

Source: Company, IIFL Research

Figure 4: Revenue breakdown by industry

Revenues by verticals	4QFY11 - % of revenues	QoQ US\$	QoQ constant currency
BFSI	35.7%	-0.3%	-0.7%
Manufacturing	20.4%	5.2%	5.0%
Telecom	11.9%	-3.8%	-4.8%
Retailing	14.5%	1.1%	1.0%
Utilities	5.8%	-3.9%	
Transportation and logistics	2.1%	17.9%	
Others	9.6%	3.4%	2.8%

Source: Company, IIFL Research

Figure 5: Revenue breakdown by geography

Revenues by geographies	4QFY11 - % of revenues	QoQ US\$	QoQ constant currency
North America	63.7%	-0.5%	-0.5%
Europe	22.1%	2.5%	1.6%
India	2.7%	24.0%	
Rest of the world	11.5%	2.9%	2.1%

Source: Company, IIFL Research

Figure 6: Revenue breakdown by service line

Revenues by service lines	4QFY11 - % of revenues	QoQ US\$
ADM	38.1%	1.1%
BPO	5.6%	1.1%
Pkg. impl. + Consulting	25.4%	-0.9%
Product engg. services	6.1%	-6.7%
Infra. mgmt.	2.4%	-2.9%
SI	6.1%	10.1%
Testing	7.3%	-2.9%
Others	3.6%	10.3%
Products	5.4%	3.0%

Source: Company, IIFL Research

Figure 7: 1QFY12 guidance summary

	1QFY12	QoQ
Revenues (US\$ m)	1,643 to 1,659	2.6% to 3.6%
Revenues (Rs m)	73,110 to 73,820	0.8% to 1.8%
EPS (Rs)	27.59 to 28.02	-13.2% to -11.9%

Source: Company, IIFL Research

Figure 8: FY12 - guidance summary

	FY12 guidance	YoY
Revenue (US\$)	7,130 to 7,250	18% to 20%
EPS (Rs)	126.05 to 128.21	5.5% to 7.3%

Source: Company, IIFL Research

Key disappointments at Infosys – 4QFY11

- Infosys missed its 4QFY11 revenue guidance (US\$1,602m vs low-end of guidance of US\$1,606m).
- Both offshore and onsite volumes were down QoQ.
- EBITDA margins dropped by 125bps in 4QFY11 (QoQ) against expectation of flat margins.
- FY12 EPS guidance of Rs128 is much below expectation. We expected Infosys to guide for an EPS of ~Rs137.
- A de-growth (QoQ) in US, telecom, BFSI and its high-end ERP/consulting businesses.

Assumptions

Y/e 31 Mar	FY09	FY10	FY11	FY12ii	FY13
Revenue growth (US\$)	12.4%	3.1%	25.7%	23.1%	18.7%
Exchange rate (US\$/INR)	46.02	47.46	45.57	44.59	44.59
Tax rate	14.4%	21.2%	26.7%	26.0%	24.0%

Source: Company data, IIFL Research

Financial summary

Income statement summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Revenue	217,023	227,396	275,010	331,601	393,538
EBITDA	72,033	78,566	89,560	102,700	120,388
EBIT	64,423	69,516	81,020	92,665	108,597
Interest income	8,710	8,810	11,110	13,582	17,167
Exceptional items	910	570	0	0	0
Profit before tax	69,653	79,196	93,040	106,247	125,765
Tax expense	-10,120	-16,810	-24,900	-27,624	-30,184
Net Profit	59,533	62,386	68,140	78,623	95,581

Cash flow summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
EBIT	64,423	69,516	81,020	92,665	108,597
Depreciation & Amortization	7,610	9,050	8,540	10,035	11,791
Tax paid	-7,940	-15,480	-24,790	-26,730	-29,344
Working capital change	-4,020	-1,130	-17,780	-4,489	-9,150
Operating Cash-flow	60,983	62,526	46,990	71,480	81,894
Capital expenditure	-13,380	-9,060	-12,590	-13,298	-19,836
Free cash flow	47,603	53,466	34,400	58,182	62,058
Dividends paid	-22,248	-13,052	-36,829	-27,185	-30,616
Net change in Cash & cash equivalents	27,780	49,140	10,870	44,650	48,609

Source: Company data, IIFL Research

Balance sheet summary (Rs m)

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Cash & cash equivalents	112,460	161,600	172,470	218,000	266,609
Sundry debtors	54,000	57,890	79,650	92,741	108,279
Fixed assets	53,540	53,550	57,600	60,863	68,909
Total assets	221,260	275,040	312,930	371,604	443,796
Sundry creditors	20,040	23,430	26,770	33,042	39,430
Other current liabilities	18,680	21,120	26,400	26,879	30,685
Networth	182,540	230,490	259,760	310,803	372,801
Total liabilities & equity	221,260	275,040	312,930	371,604	443,796

Ratio analysis

Y/e 31 Mar	FY09A	FY10A	FY11ii	FY12ii	FY13ii
Sales growth (%)	30.0	4.8	20.9	20.6	18.7
Core EBITDA growth (%)	37.5	9.1	14.0	14.7	17.2
Core EBIT growth (%)	38.8	7.9	16.5	14.4	17.2
Core EBITDA margin (%)	33.2	34.6	32.6	31.0	30.6
Core EBIT margin (%)	29.7	30.6	29.5	27.9	27.6
Net profit margin (%)	27.0	27.2	24.8	23.7	24.3
Dividend payout ratio (%)	21.9	22.5	58.9	35.2	35.1
Tax rate (%)	14.5	21.2	26.8	26.0	24.0
Net Debt/Equity (%)	61.6	70.1	66.4	70.1	71.5
Return on Equity (%)	37.2	30.2	27.8	27.6	28.0
Return on Assets (%)	29.2	24.9	23.2	23.0	23.4

Source: Company data, IIFL Research

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.

SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.

Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.

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