INFOSYS TECHNOLOGIES

INR 1,630

Edelweiss
Ideas create, values protect

Budgets still uncertain, near-term visibility hazy

ACCUMULATE

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Viju George
+91-22-4009 4295
viju.george@edelcap.com

Kunal Sangoi
+91-22-2286 4309
kunal.sangoi@edelcap.com

Nikhil Chakrapani
+91-22-2286 4410
nikhil.chakrapani@edelcap.com

We met the management of Infosys Technologies (Infosys) for an update on the company's perception of the current business environment. It is middle of Q4FY08 and we wanted to understand if the company is seeing greater visibility in clients' budgets now than it had offered at the time of its Q3FY08 results. The answer: visibility in budgets from select customers in certain key segments is still awaited (BFS, manufacturing, and retail—collectively, these three verticals contributed about 56% of Infosys's Q3FY08 revenues). We got the impression that while the company is still seeking greater visibility for the next two quarters, it is relatively more confident of two outcomes: (a) maintaining operating margins through FY09 within a narrow band of that in FY08; and (b) a back-ended growth in FY09 as clients work through their budgets in the course of the year.

Our conclusion is that while Q4FY08 and Q1FY09E could be slow quarters for the company (USD sequential growth of about 5%), earnings growth of over 15% in FY09E still seems likely as the headwind of the INR appreciation against the USD seems less pronounced in FY09 versus FY08. But investors are likely to seek greater visibility from the company as it will articulate in its outlook for FY09 even as current valuations seem reasonable. We believe that the company should be a little more willing to give up its ***"Margins first, revenues next"*** philosophy to drive greater penetration among clients and markets it historically may have shied away from. In our view, maintaining a near 30% annual USD growth over the existing revenue base (about USD 4.2 bn in FY08) for the next two-three years may necessitate relenting on margins vis-à-vis Infosys's traditional stance.

We still like the Infosys story but see near-term uncertainty capping near-term stock opportunities. The stock has returned 18% since our report on January 23, titled ***'3 options for the investor'*** advocating buying into valuations .

Our revised DCF suggests a fair value of about INR 1,950, an adjustment we are making for a riskier growth scenario in FY09E. **Consequently, in light of the tough macro-environment and the recent brief rally, we are downgrading our recommendation on the stock to 'ACCUMULATE' from BUY.** The stock has potential to return up to 20% returns over a 12 month perspective but that assumes the confidence of a back-ended growth in FY09E, an assurance we do not fully have today. Near-term visibility is an issue and margins have likely peaked; hence, the stock performance over the next 3-6 months is likely to be unexciting.

Financials

Year to March	FY07	FY08E	FY09E	FY10E
Revenues (INR mn)	138,930	166,209	211,831	258,473
Rev. growth (%)	*45.9*	*19.6*	*27.4*	*22.0*
EBITDA (INR mn)	43,910	52,063	67,786	81,290
Net profit (INR mn)	38,560	46,494	55,745	61,568
Adj. shares outstdg (mn)	557	572	576	580
Adj. EPS (INR)	69.2	81.3	96.9	106.2
EPS growth (%)	*53.7*	*17.5*	*19.1*	*9.7*
PE (x)	22.6	19.3	16.2	14.8
EV/EBITDA (x)	19.1	15.5	11.3	8.9
ROE (%)	42.3	35.6	32.5	27.9

Reuters	:	INFY.BO
Bloomberg	:	INFO IN

Market Data

52-week range (INR)	:	2,376 / 1,212
Share in issue (mn)	:	571.6
M cap (INR bn/USD mn)	:	932 / 23,233
Avg. Daily Vol. BSE ('000)	:	1,867.7

Share Holding Pattern (%)

Promoters	:	16.5
MFs, FIs & Banks	:	7.1
FIIs	:	33.3
Others	:	43.1

Other key takeaways

* Budgets versus spending mismatch could be seen in FY09E

Unless visibility improves, clients could end up spending less than what they have budgeted for. This is contrary to the situation in FY07 where several of Infosys's clients grew ahead of their budgets fixed with Infosys and much ahead of Infosys's own expectations. The company is cognizant of this and it could be one factor contributing to the company's caution apart from the fact that some clients have not reverted with budgets yet.

* Outperformance of guidance is measured this time, could continue to be so going ahead

Infosys is likely to end FY08 with a growth of about 35-36% in USD terms; the outperformance relative to its guidance for FY08 issued at the time of Q4FY07 results of 28-30% is modest (absolute outperformance is just 5-6% and this pales in comparison with Satyam). The company took pains to point out that the guidance must be seen as realistic and not conservative; in a way, guiding down the Street expectations that tend to be pegged much above the company's guidance.

* Margin levers: A mixed story

Infosys believes that there are still margin levers in its operating model in the form of scope to rationalize onsite costs and increasing variabilization of pay (about 30% of pay is variable). But on the other hand, offsetting these factors, we believe that SG&A has been tightly controlled and there must be further investment hereon. Also, we observe that offshore contribution as percentage of revenues is 52.2% in Q3FY08, the highest in the last 20 quarters and which might be difficult to maintain going forward. Hence, margins may present a stable picture at best with possibly a slight downward bias.

* Focus on improving realizations is unremitting

Infosys's impressive sequential pricing improvement over the past six quarters (1.8% onsite and 1.5% offshore per quarter) partly rests on its ability to drive IPR-based solution-led sales in certain verticals such as BFSI and retail (about 10% of revenues today). This revenue stream is given primary thrust—evidenced by the merging of the solutions group and the consulting arm and given clear consistent targets. We understand that the company is setting aggressive internal targets as this remains a central plank to maintain the company's industry-leading EBITDA margins.

* Outlook contrasting among players in the sector

While on the one hand, Satyam, Wipro, Cognizant and even a much small player like MindTree Consulting sound relatively confident in the current environment, on the other, TCS and Infosys are holding us down to greater caution (more so Infosys). Sales cycles are no doubt lengthening and engagement levels are being escalated to the CXO level. There could be vendor consolidation at play to Infosys's benefit, but this process will work through in the course of the year, hence, lending credence to the "back-ended growth" theory, which is not without risk.

Finally, the revenue outlook for the company for FY09E is calibrated by taking a top-down as well as bottom-up approach to clients. Utilization is assumed at between 76% and 78% (in line with the company's historical average) with a gross lateral: fresher intake of 1:2. Also, Infosys assumes a 1:2:5 pyramid in its typical project delivery (1- senior engagement manager, 2 - project manager, and 5 – freshers or less experienced professionals), which forms the base of its cost delivery. The management normally has good visibility for the immediate quarter (>90%)

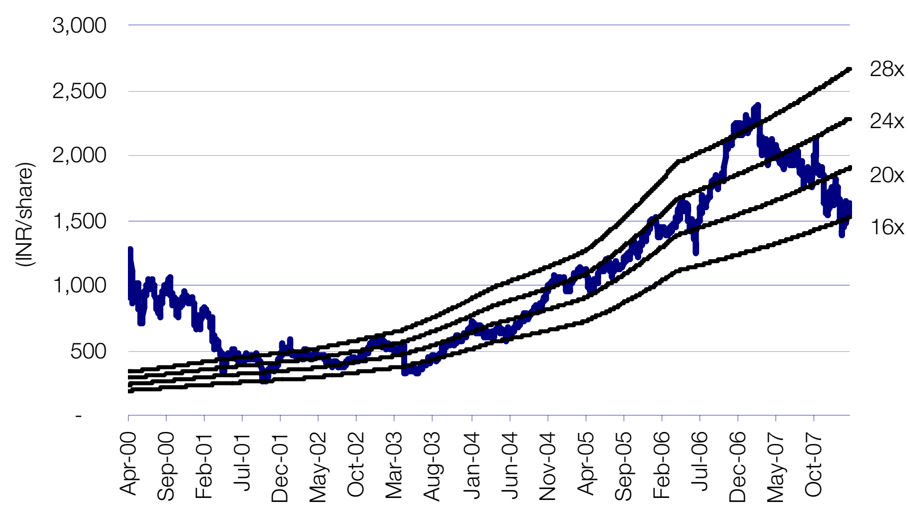
and a still decent 80-85% confidence on the full year guidance. However, the company's internal targets (on which bonuses and variable pay are based) are usually higher than the guidance.

* Outlook and valuations: reasonable but little near-term upside; downgrading to 'ACCUMULATE'.

The investor could point to Infosys's weakening Y-o-Y metrics (volume growth, INR revenue growth, EBIT growth) and assert that they have not bottomed out yet. We agree with this viewpoint, but barring an outright deep recession which could significantly unnerve or topple IT budgets, we believe that stock prices are already factoring in one more quarter of continued weakening of metrics (Y-o-Y) but perhaps not beyond that.

We still like TCS, Satyam, and HCLT. We must point out that Infosys's exposure to the other "problem" segments such as manufacturing and retail (about 27% of revenues) is relatively large and needs to be monitored. In that context, TCS is better placed in this environment by way of a lower exposure (20%). Infosys has the ability to crank up revenues if it lets up on margins and the company could be tested on this flexibility in this environment. In light of the tough macro-environment and the recent brief rally, we are downgrading our recommendation on the stock to 'ACCUMULATE' from 'BUY'. The stock has potential to return up to 20% returns over a 12 month perspective but that assumes the confidence of a back-ended growth in FY09E, an assurance we do not fully have today. Near-term visibility is an issue; hence, the stock performance over the next 3-6 months is likely to be unexciting.

Chart 1: Valuations are still reasonable but near-term outlook remains hazy



Source: Edelweiss research

Edelweiss
Ideas create, values protect

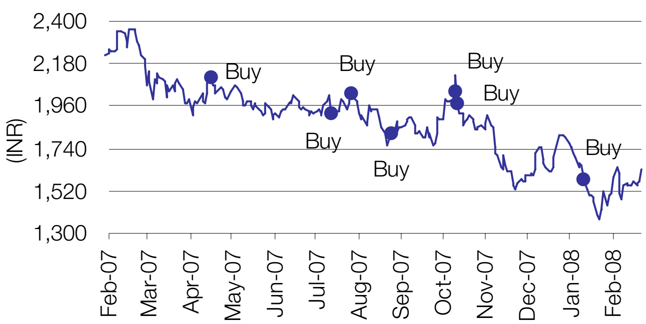
Edelweiss Securities Limited, 14th Floor, Express Towers, Nariman Point, Mumbai – 400 021, Board: (91-22) 2286 4400, Email: research@edelcap.com

Naresh Kothari	Co-Head Institutional Equities	naresh.kothari@edelcap.com	+91 22 2286 4246
Vikas Khemani	Co-Head Institutional Equities	vikas.khemani@edelcap.com	+91 22 2286 4206
Shriram Iyer	Head Research	shriram.iyer@edelcap.com	+91 22 2286 4256

Coverage group(s) of stocks by primary analyst(s): Information Technologies:

Geometric, HCL Tech, Hexaware, i-flex, i-Gate, Infosys, Infotech, Mastek, Mphasis, Patni, Rolta, Sasken, Satyam, TCS, and Wipro

Infosys Technologies



Recent Research

Date	Company	Title	Price (INR)	Recos
15-Feb-08	IT Fact Sheet			
13-Feb-08	TCS	Sustainable growth is the theme*; Event Update*	869	Buy
8-Feb-08	Patni Computers	Lacklustre performance *Result Update*	273	Accumulate
5-Feb-08	I-Flex Solutions	Margins improve, but concerns persist; *Result Update*	1,111	Accumulate

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Accumulate	Reduce	Sell	Total
Rating Distribution*	112	44	11	1	188

* 14 stocks under review / 6 rating withheld

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	88	74	26

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 20% over a 12-month period
Accumulate	appreciate up to 20% over a 12-month period
Reduce	depreciate up to 10% over a 12-month period
Sell	depreciate more than 10% over a 12-month period