INFOSYS TECHNOLOGIES

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To guide or not to guide; what will Infosys do? ACCUMULATE

March 3, 2009

Almost exactly a year back our report on Infosys, ***To guide or not to guide,*** dated 26th March 2008, estimated the likelihood of the company's FY09 revenue growth guidance to be at 18-20% in USD (the company guided for 19-21% at the time of its Q4FY08 results). In this note, we examine the rising complexities of Infosys giving guidance for FY10 in an increasingly foggy environment. Notably, Wipro has already indicated that it is seriously re-examining the advisability of continuing guidance.

We examine the pros and cons of withholding guidance in current times and what it means for Infosys. We conclude that on balance, for a company like Infosys committed to investor loyalty and principled investor communication, the moral arguments in favor of guidance rule heavily. Further, we believe that Infosys is likely to take a somewhat conservative view in assuming a second half recovery in its FY10 guidance.

We discuss various revenue guidance scenarios. **On the basis of the company's tepid exit revenue run rate in Q4FY09 (absolute USD revenue in Q4FY09 is likely to be the lowest among the four quarters in FY09), we believe it is likely to guide to a -3.5% to 1.5% revenue growth (in USD) in FY10*. In particular, we note that our estimated guidance range of 5% (-3.5% to +1.5%) is likely to be much wider than normal.**

Q1FY10 guidance could be more critical than full FY10 guidance

Critically though, in our view, guiding for above 1.5-2.0% USD revenue growth in FY10 factors in some measure of H2 strength or recovery that Infosys and investors may not be comfortable in assuming currently. Also, with investors likely to focus on recovery indicators and on how the near-term is panning out, Q1FY10 guidance is likely to assume disproportionate importance relative to fiscal FY10, especially if the latter is premised on a recovery in H2. Also, with the FY10 guidance band being at least as wide as we expect, investors may tend to treat the annual guidance as less of an event and pay greater heed to the quarterly outlook (guidance).

Outlook and valuations: Caution warranted; maintain 'ACCUMULATE'

We continue to remain cautious on the sector (Market Underweight) despite attractive valuations. Investors who like free cash flows will continue to like Infosys in a difficult environment as free cash flow (as % of revenues) trends up in a difficult environment as capex scales back. Also, in a weak revenue environment, the company is best placed to manage profitability by virtue of its industry-leading margins, most flexible cost structure in the industry, and its light hedging position, allowing it to gain most from a depreciating INR (against USD) in the near term. Infosys trades at 11.8x FY09E and 12.1x FY10E earnings. We maintain our **'ACCUMULATE'** recommendation.

**Continuing adverse cross-currency impact is a downside risk to our lower-end point estimate (3.5% decline) as discussed further on in this report*

Financials

Year to March	FY07	FY08	FY09E	FY10E
Revenues (INR mn)	138,930	166,920	218,231	219,693
Growth (%)	*45.9*	*20.1*	*30.7*	*0.7*
EBITDA (INR mn)	43,910	52,380	72,468	72,024
Net profit (INR mn)	38,500	46,590	58,176	56,759
Adj. shares outstdg (mn)	557	571	573	573
Diluted EPS (INR)	67.6	81.3	101.5	99.0
EPS growth (%)	*50.1*	*20.2*	*24.8*	*(2.4)*
Diluted P/E (x)	17.3	14.7	11.8	12.1
EV/EBITDA (x)	14.3	11.7	7.8	7.2
ROAE (%)	42.3	37.2	35.5	26.6

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Reuters	:	INFY.BO
Bloomberg	:	INFO IN

Market Data

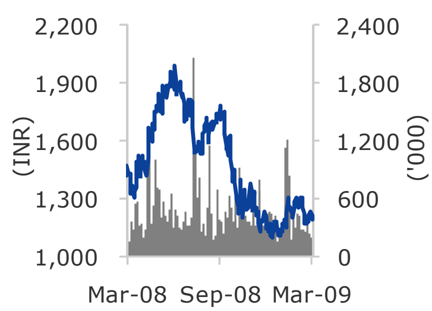
52-week range (INR)	:	2,017 / 1.040
Share in issue (mn)	:	572.6
M cap (INR bn/USD mn)	:	698 / 13,510
Avg. Daily Vol. BSE ('000)	:	2,253.5

Share Holding Pattern (%)

Promoters*	:	16.5
MFs, FIs & Banks	:	8.6
FIIs	:	33.0
Others	:	41.9
* *Promoters pledged shares (% of share in issue)*	:	*Nil*

Relative Performance (%)

	Sensex	Stock	Stock over Sensex
1 month	(6.8)	(6.7)	0.2
3 months	(2.6)	0.2	2.9
12 months	(48.4)	(18.6)	29.8



Analysis of firms that discontinued guidance in better times proves that in general such firms have under-performed in subsequent quarters due to specific difficulties. Some have gone through internal upheavals or events such as change of management, with the new management wanting to start on a fresh slate with investors (see appendix A which summarizes the results of an influential, detailed academic study in the US that examines the consequences of stopping guidance).

But today the case for withholding guidance is gaining currency as investor appreciation is developing about the difficulty of guiding amidst unprecedented uncertainty. Global bellwethers such as GE, Unilever, and Microsoft, citing unprecedented economic distress have suspended giving guidance. While we believe that Infosys continues to see the benefits of sustaining guidance as overwhelming, we argue that consequences of living up to it are not always optimal.

Table 1: A few instances of bellwethers suspending guidance; several of them have done so in the current environment

Companies that have lately stopped giving guidance (in the current environment)	Rationale as per company	Period	Stopping guidance (interim/ quarterly/ yearly)	Performance after discontinuing guidance
Intel	Economic uncertainty and limited visibility	Jan-09	Stopped providing mid-quarter updates but continues to issue yearly and quarterly guidance	Insufficient data points
GE	No idea how long this downturn will last, or how much worse it will get	Dec-08	The company most associated with meeting its quarterly numbers is no longer going to be forecasting them	Insufficient data points
Capgemini	H2 is too unpredictable and visibility is low	CY09	Only H1 guidance given and not H2	Insufficient data points
Unilever	It was “not a good moment” to give long-term targets	Feb-09	The company has stopped giving annual guidance, i.e., for CY09 and CY10	Insufficient data points
GlaxoSmithKline	It wanted the market to focus more on the long term	Feb-09	The company has decided to stop giving guidance for investors (quarterly)	Insufficient data points
Wolfson Microelectronics	Poor market visibility prevented it from giving guidance	Feb-09	The company could not give guidance on revenue prospects	Insufficient data points

Companies that have stopped giving guidance (in earlier times)	Rationale as per company	Period	Stopping guidance (interim/ quarterly/ yearly)	Performance after discontinuing guidance
Coca-Cola	"We pay too much attention to short-term results"	Dec-02	Coca Cola has stopped giving quarterly and yearly profits forecasts	Generally exceeded expectations
McDonald's Corp	“The company is focused on delivering improved results over the long term. Therefore, the company will not be providing earnings per share targets by quarter or for the year”	Jun-05	Moved away from giving quarterly guidance	In line or slightly more than consensus estimates
General Motors	Given the uncertainty affecting key elements of the financial forecast, the company has determined that it will not provide earnings guidance for the calendar year at this time	Apr-06	The company declined to give guidance about when it might return to profits	Significantly down from consensus estimates
Ford	"We're not giving financial guidance today and we won't do that for some time," Don Leclair, chief financial officer	Apr-06	Stopping guidance for some time, also the company has postponed the target year of profitability from 2008 to 2009	Significantly down from consensus estimates

Source: Edelweiss research

Arguments in favor of withholding guidance in current turbulent environment:

1. Investor expectations are now considerably moderated; they understand the volatilities buffeting the environment currently and the difficulties thereof of articulating guidance.

2. **Global bellwethers have stopped giving guidance.** Even perceived defensives such as Unilever have discontinued giving guidance for CY09.

3. Guidance for multiple classes of shareholders who hold the stock of the company on different country-exchanges (the local-India listed, ADR-listed shareholders) poses peculiar risk in this environment for Infosys as we go on to show in this report. It could drive firms to take sub-optimal decisions.

4. **Should firms assume a H2 calendar recovery in their guidance?** In the current environment, observers and commentators believe this to be an unlikely scenario. Indeed, the market may treat any assumptions in guidance predicated on back-ended growth with skepticism. Infosys did assume some strength in the second half of FY09 in its annual outlook last year and in hindsight, we now appreciate the risks in assuming this.

5. **Compensate lack of guidance by improved level of forward looking disclosures.** Firms can accompany their commentary and discussion with much more color and detail than usual on the qualitative and quantitative aspects of their business that provides some clarity to investors. However, this does not apply to Infosys, whose typical earnings release is accompanied by an admirable depth of information of both kinds. The flip side of this argument is that such extra detail may not be fully meaningful unless it is linked back to a publicly avowed financial number target that investors can more easily relate to.

Arguments against withholding or discontinuing guidance:

1. **Retaining the confidence and loyalty of certain class of investors may be difficult if companies withhold guidance owing to a difficult environment.** This argument has particular resonance with Infosys which prides itself on its discipline in giving guidance dating back to 2002. It first burst the tech bubble to Indian investors with its revenue guidance in 2002 of 30% (USD terms) after posting more than 100% growth in 2001. Some investors, over a period of time, expect the company to always give guidance, no matter what. Consistency of action has contributed in part to the Infosys brand equity with investors.

2. **Companies through guidance give investors the confidence that they are always in control of their business and have a gauge at any moment in time.** The fact that the gauge may yield strongly variant/volatile measurements across time periods does not negate the trust and reassurance that companies such as Infosys afford investors with willingness to continue guidance. This argument is also likely to resonate strongly with Infosys.

3. **Senior executives or managers must be held accountable to public targets which articulation of guidance provides.** Some firms, including Infosys, endorse this point of view but we disagree with it. Targets could be aggressive but need not necessarily be public. Managers can just as easily be strictly assessed against internal targets and their compensation tied to them. Making them public does not necessarily mean that higher growth is achieved or that managers make the right business decisions.

4. **Guidance plays a valuable role because it ensures that investor expectations do not get out of hand.** The disparity between actual earnings and the consensus estimate will only be larger than it is as uncertainty plays out. Over the years, the spread or dispersion of consensus estimates of Infosys is minimum relative to that for other companies in the sector. Without guidance, the gap between actual earnings and the consensus estimate will only be larger.

5. **Finally, companies such as Infosys can widen the span of their guidance band which gives them somewhat greater leeway.** We see that quarterly revenue growth guidance of Infosys for the past two quarters has implied a near 4% range (in Q3FY09 it stood at an implied -3.4% to 0.3% growth while for Q4FY09 revenue guidance was in a 0-3.6% decline range), wider than the normal 1% quarterly range that the company has customarily guided in.

What does it all add up to?

On balance, for a company like Infosys, committed to investor loyalty and principled investor communication, the moral arguments in favor of guidance heavily rule. Also, we believe that Infosys is likely to take a somewhat conservative view of assuming a recovery in second half in its guidance. **On the basis of the company's tepid exit revenue run rate in Q4FY09 (absolute USD revenue in Q4FY09 is likely to be the lowest among the four quarters in FY09), we believe it is likely to guide to a -3.0% to 2% revenue growth (in USD) in FY10. In particular, we note that the FY10 growth guidance range at 5% is likely to be much wider than normal. A guidance band with range exceeding 4-5% is likely to offer less clarity to the investor and only conveys Infosys' uncertainty. In our view, the likelihood of negative USD growth is significant and it takes assumption of meaningful H2 recovery for us to see Infosys' revenues grow ahead of 1.5-2% in FY10 (USD).**

Risks to our guidance estimate. We do not factor in any further meaningful adverse impact of cross currency from now (March 3rd) to March 31 due to the continuing appreciation of the USD. Notably, the GBP, Euro and AUD have already depreciated 2.5%, 11% and 10% respectively against the USD in 2009 so far (since December 31, 2009). Thus, there is further cross-currency risk to our estimated Infosys guidance which will be clear as of March 31, 2009. As of now, we believe that we are adequately capturing pricing and volume pressures in the business.

INR-USD equation continues to remain the joker in the pack

The INR-USD equation continues to remain the joker in the pack as Infosys bases its INR-based guidance on the closing exchange rate as of March 31, 2009. Thus, the INR-denominated guidance numbers (revenues and EPS), which currently we estimate at high single-digit growth (%) at INR-USD current exchange rate levels of ~51-52, are unlikely to hold if the equation appreciates hereon. We will have more to say on FY10 EPS growth after the current quarter (Q4FY09).

Q3FY09 dilemma a result of dual quarterly guidance

Restated for constant currency and excluding tax write-backs, Infosys just met its Q3FY09 EPADS guidance of USD 0.56 (precisely in fact), while it handsomely exceeded it for India-based investors (actual EPS of INR 28.6 versus guidance of INR 26.6). **We believe Infosys may have sub-optimised its SG&A spend in Q3FY09 to meet its ADS EPS guidance.** These huge volatilities in cross-currency equations and attendant forex losses of USD 45 mn (as per IFRS) put a company like Infosys (which provides sequential EPS guidance for shareholders of local-listed shares as well as holders of its ADS) at a disadvantage. The company may well exceed one of the two (like EPS in INR in Q3FY09) but risk missing the other. We believe it will be more judicious for the company to look at SG&A investments from a strategic perspective, to strengthen competitive advantage and spend to the required degree even if the quarterly EPS guidance for either of the two classes of shareholders is at risk as a result.

Q3FY09 also told us that Infosys prefers to preserve margins to the extent possible to meet EPS guidance for both the India-stock and ADS holders even if some investments have to be cut back to do so. Also, we note that the company did not live up to its stated intent of reinvesting the gains from the INR depreciation back in to the business owing to extreme cross-currency that threatened its ADS (EPS) guidance.

What does investor reaction to FY09 guidance teach us one year later?

The enthusiasm for and confidence in back-ended growth (viz., strong recovery) was significantly higher in April 2008 compared to today. This is because Infosys had not missed revenue guidance in its seven-year guidance history till then (FY08). This perhaps explains why investors responded well to Infosys' FY09 guidance last year at around this time despite a damp Q1FY09 revenue outlook (guidance was for 1% sequential Q-o-Q growth in Q1FY09 versus consensus expectations of 2-3%). Subsequent quarters belied the notion of "back-ended" growth as Infosys will fall well short of the initial 19-21% growth guidance. But today, investor confidence in back-ended growth is low and therefore, prognosis of a back-ended thesis playing out in FY10 may cut little ice with investors.

To guide for an increased guidance range or not?

We believe Infosys may increase the guidance band in an uncertain year. But we caution that the company is walking a fine line between allowing for uncertainty and ensuring meaningfulness in its guidance. A wider range than what we expect (>4-5%) in the guidance band conveys little meaning to the investor because it factors in a range of outcomes ("a tepid FY10 throughout or no H2 recovery" to "mild H2 recovery" to a "decent H2 recovery") that offers no "clear" picture. Besides, such a wide band would also convey the company's uncertainty on its own outlook.

To guide for back-ended growth or not?

This is a relevant question that Infosys faces on the aspect of guidance. We believe that unlike Cognizant which assumed some recovery in H2CY09, Infosys may not do so. Thus, it becomes difficult to see how Infoys can guide for positive revenue growth (USD) in FY10 exceeding a meager/token benchmark of say +1.5-2%. Anything exceeding this may need decent recovery in H2.

To guide for stable pricing or not?

The decision of whether or not to factor in declining pricing in the quarters ahead in Infosys' guidance assumes interesting hues in the view of the company's customary practice of assuming constant pricing (with respect to pricing in the most recent quarter) in its guidance. This practice was conservative in the context of a benign pricing environment earlier. Today, this assumption is aggressive and hence, the company is likely to provide for declining pricing outlook in its FY10 guidance (relative to its Q4FY09 realized pricing).

We forecast a USD revenue growth guidance band of -3.5% to 1.5%. Admittedly, this is a wide range but factors in the following assumptions as per the bearish case, base-case and favorable case in Table 2.

Table 2: Our base case scenario envisages a revenue decline of 1.5%, bear-case decline greater than 3.5%

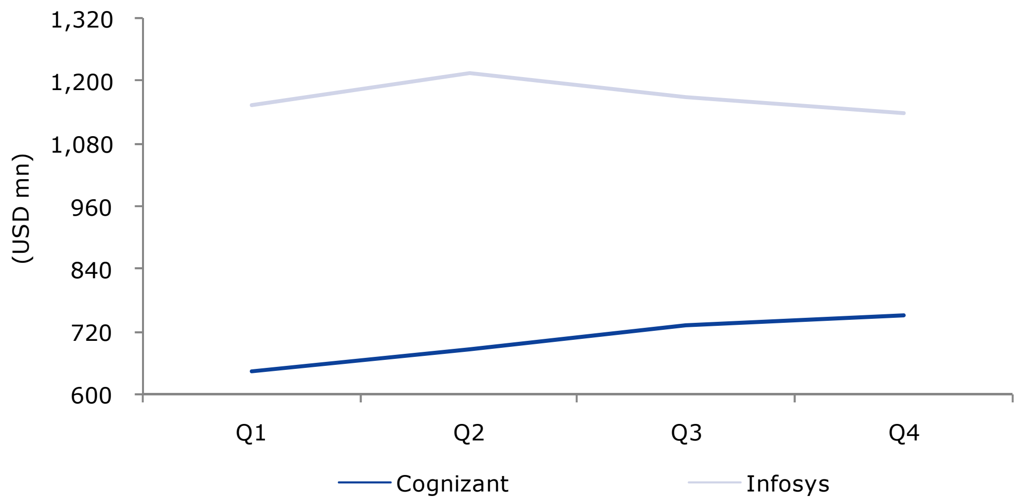
	Bear-case scenario	Base-case	Bull-case scenario
IT Services	FY10 volume growth flat to negative (<0)	FY10 volume growth in low single digits (2-4%)	FY10 volume growth in mid-high single digits (>5%)
	Y-o-Y pricing decline > 450bps	Y-o-Y pricing decline about 400bps	Y-o-Y pricing decline between 300bps and 400bps
	IT-services revenue decline > 4.5%	IT-services revenue decline about 1.5-2%	IT-services revenues > 0%
BPO	Moderate growth of 5-10% assumed	Growth of about 10% assumed	Growth > 10% assumed
Overall FY10 revenue performance (versus FY09)	**Decline > 3.5%**	**Decline of 1.0-1.5%**	**Growth > 1.5-2%**

Source: Edelweiss research

FY09 revenue profile places Infosys at relative disadvantage; focus will be on Q-o-Q trends

Infosys is likely to end FY09 at the lowest revenue count (USD) in its four quarters of FY09. Therefore, for the reverse mirror image of the sequential revenue pattern in FY09 to play out in FY10 (i.e., flat revenues in FY10 vis-à-vis FY09), a mild revenue pick up is necessary. The law of weak exit rate is playing out in Infosys' case. For example, if the Infosys guidance ambitiously replicates Cognizant's sequential asking rate as per its FY10 guidance (-2.2% decline in Q1 and 3.6% Q-o-Q growth through Q2-04), its revenue growth in FY10 would be just 1.4%, compared with 10% for Cognizant. (Note that Cognizant, on the other hand, ended its Q4CY08 revenue quarterly count at its peak (USD 753 mn). Investors are cognizant of this arithmetic and therefore, we believe the focus will be more on Q-o-Q trends and patterns, and less on Y-o-Y (see chart 1).

Chart 1: Infosys is exiting FY09 at its lowest revenue base for the year while Cognizant exits CY08 at a peak



Source: Company, Edelweiss research

What operational margin levers are available to Infosys for FY10?

As companies tighten SG&A, considerably moderate wage hikes, increase fixed price delivery, improve offshore mix as a percentage of effort and revenues, the levers at their disposal to manage margins in the face of certain pricing pressures, volume growth challenges, and uncertain utilisation are fast diminishing. Infosys is likely to stagger the on-boarding of freshers (to whom it had made about 20,000 offers to join in CY09/FY10) to limit margin impact of uncertain utilisation. **The Indian IT industry enters FY10 with few meaningful levers available to manage costs, except the variable pay of employees.** Infosys is better off here with about 30% of its offshore pay and about 5% of onsite pay variable (650bps, of which about 300-350bps can be realistically retained), the maximum among its peers. **In a weak revenue environment, margin management is likely to be difficult through FY10 with Infosys holding the aces (see table 3).** Needless to add, the depreciating INR undermines our argument that margins are at risk. It will be interesting to see to what extent and where Infosys invests the excess margins accruing from the continuing INR depreciation.

Table 3: Infosys' margin change for FY10 attributable to various factors

Factor	Impact on margin (bps)
Bench cost	(50)
S&M	(100)
Wage increase/Promotions	(50)
Pricing (400 bps decline Y-o-Y)	(360)
Utilization	100
Variable pay retention	350
G&A saving	50
Total	**(60)**
Provided by INR depreciation	??
Net impact on margins after INR depreciation	**??**
Reinvestment of excess margins	??

Source: Company, Edelweiss research

Relative spread of growth in good versus difficult times is maximum for Indian IT sector

The spread of revenue outlook is considerably narrowed for Indian IT companies in bullish times versus bearish times compared to their global counterparts. For example, Cap Gemini grew about 8% over the past three years (ex-acquisitions) on revenues while for Infosys it has been 30% (over 2006-09) (see table 4). This is now converging in to near-zero for both; thus, the revenue spread between good and bad years is maximum for Indian than global players. We draw two conclusions from this: (a) the defensiveness of offshore spending is perhaps overstated; and (b) the offshore environment to a good extent has also thrived on a portfolio of discretionary services (business intelligence, enterprise solutions – specifically new license package implementation and new product development), and on the boom in buoyant times in specific verticals (viz., financial services, telecom service providers, retail).

Table 4: The dispersion of revenue growth between good and bad years is maximum for offshore service providers such as Infosys

	3-year revenue CAGR % (a)	Growth guidance (%) for CY09/FY10 (b)	Spread = (b) - (a)
Accenture	14	NA	NA
Capgemini	8	(2)#	(10)
Atos Origin	1	(2)	(3)
Infosys	30	(1)*	**(31)**

** mid point of our guidance range from -3.5 to 1.5*

 # includes H1 guidance only

Source: Company, Edelweiss research

With long-term moderation likely in these segments/verticals, the huge gap in growth rates that Indian IT has opened in the past relative to its global counterparts may not repeat, especially as global peers (particularly Cap Gemini more lately, the significant presence of IBM and Accenture is already well documented) step up their focus on their India presence, making it a central plank of their cost containment/reduction strategy.

Appendix A: To Guide or Not to Guide - A Look at Earnings Guidance

This research summary was originally published by the New York University Stern School of Business. It was written by Joel F. Houston, Baruch Lev and Jennifer Tucker. Reproduced with kind permission.

Earnings guidance -- managers' public forecasts of forthcoming earnings -- is a widespread, yet highly controversial practice. A recent position paper by the CFA [Chartered Financial Analyst] Institute and the Business Roundtable emphatically recommended that corporate leaders "end the practice of providing quarterly earnings guidance." Purists argue that managers should leave securities valuation and the underlying forecasts of future performance to investors and analysts. Lawyers warn that earnings guidance increases litigation exposure. Regulators and commentators fret that previously issued forecasts motivate managers to meet forecasts even when doing so requires them to cut advertising or research, or, worse, to manage earnings. Others object that quarterly guidance leads managers to cater unduly to the demands of short-term investors.

All in all, concludes McKinsey & Co., "earnings guidance is misguided." But managers often claim that guidance is necessary to keep analysts' earnings forecasts within a reasonable range to avoid large earnings surprises that increase stock price volatility. Some observers note that successful earnings guidance enhances investor confidence in managers' ability. And economic theory teaches that credible and relevant information disclosures, such as high-quality earnings guidance, decrease information asymmetry and improve resource allocation in the capital markets.

Who is right? We believe that the answer relies less on opinion and more on data. We set out to investigate the countervailing claims about guidance by looking at the financial and economic consequences of guidance. To do so, we constructed a series of tests that compared the performance of companies that stopped issuing guidance after having done so, with the performance of those that continued to offer guidance. The intriguing results suggest that reducing disclosure by stopping guidance benefits neither investors nor companies.

Stoppers and Maintainers

Using the First Call Company Issued Guidelines (CIG) and Factiva news databases, we compiled a sample of 222 firms that stopped giving guidance between the first quarter of 2002 and the first quarter of 2005, along with a sample of 676 guidance maintainers. "Guidance stoppers" were firms that issued guidance for at least three out of the four pre-event quarters, but gave no guidance for any of the four post-event quarters. Those that provided guidance for at least three out of the four quarters in *both* the pre- and post-event periods were termed "guidance maintainers."

First we examined the financial reasons for stopping guidance. Compared with the guidance maintainers, we found that guidance stoppers in each quarter before they stopped guidance reported losses and earnings declines (compared with the year-before quarter) more frequently, while guidance maintainers met or beat consensus forecasts more frequently. Compared with the overall population of U.S. firms, guidance stoppers performed worse in each of these three areas while guidance maintainers performed better. More important, we found that as the stoppers approached the event quarter, they *increasingly* suffered losses, earnings declines, and a failure to meet or beat analyst consensus. This pattern was reversed for the maintainers.

Several other metrics pointed to greater instability and poor performance among stoppers. During the pre-event (stopping) period, relative to maintainers, the stoppers more often experienced a change of CEO/CFO, had higher earnings uncertainty, higher incidences of losses, larger decreases (or smaller increases) in earnings, and poorer records of meeting/beating either analyst consensus or their own earnings estimates. The stoppers meet or beat analyst expectations only 69.2 percent of the time, while the maintainers' did so 83.3 percent of the time. Reflecting their relatively poor performance, the stoppers posted lower market-adjusted stock returns in the pre-event period than did the maintainers. A similar dynamic could be seen *after* guidance was halted. Relative to the maintainers, the stoppers suffered from significant decreases in analyst coverage, significant increases in analysts' forecast dispersion and forecast error, and experienced no changes in capital expenditures and R&D spending.

Guidance detractors often argue that guidance isn't necessary because managers aren't any better at predicting earnings than analysts and investors. To test this claim, we studied the usefulness of quarterly guidance in two ways. First, we tested the extent of analyst revisions of earnings forecasts following the issuance of company guidance. Collecting the last forecast issued by an individual analyst before and immediately after the release of company guidance allowed us to chart the direction of analyst forecast revisions following guidance. (To avoid confounding news, we excluded guidance issued concurrently with quarterly earnings announcement events.)

We found that for both negative and positive guidance, over 50 percent of analyst revisions were made within two days of the guidance and that 96 to 98 percent of these revisions were in the direction of the guidance. This remarkable correspondence between guidance and analyst revisions attests to the usefulness of company guidance.

Second, we gauged the accuracy of guidance by comparing company guidance with the subsequent reported earnings, and with the most recent analyst forecast issued before the guidance. In 70 percent of the cases, company guidance was more accurate than analysts' forecasts.

Changing Direction

Given these findings, it's something of a mystery why firms would stop offering guidance. Most firms did not announce or explain changes in their guidance policies. Among those that did, frequent reasons for stopping were the redirection of investors' attention from quarterly earnings to the long-term goals of the company, managers' difficulties in predicting earnings, and following peer firms' guiding practices. When the National Investor Relations Institute (NIRI) asked members contemplating discontinuing guidance to list the reasons why they were considering doing so, the top three were a change in management philosophy (47 percent), industry trend (27 percent), and low earnings visibility (25 percent).

There clearly is something to what the respondents said. For example, a change in management philosophy regarding guidance most likely occurs with a change in the top management. When we ran the numbers, we found that firms are more likely to cease guidance if they have recently undergone or plan a change in their senior management. And when we looked at the proportion of companies in the firm's two-digit SIC [Standard Industrial Classification] code that *did not* provide any quarterly guidance in the pre-event period, the data showed that a firm is more likely to stop guidance if a larger proportion of its industry peers did *not* provide guidance.

Furthermore, we expect that a new management team is more willing than an existing team to steer the firm's guidance policy away from popular practices in its industry. We also found that past and anticipated difficulty of forecasting earnings contributed to guidance cessation.
Beyond these stated reasons, however, there may be an unstated yet important motive for stopping guidance: poor performance. The existing academic body of evidence on voluntary disclosure strongly indicates an increasing tendency to disclose in good times and, by implication, a decreasing tendency to disclose when performance deteriorates. And we found strong and consistent evidence that poor performance -- both realized and anticipated -- contributed to firms' decision to stop guidance.

In our tests, the probability of stopping guidance was significantly and negatively associated with past earnings performance and with anticipated future poor performance. Meanwhile, firms with a higher litigation risk were more likely to cease guidance, suggesting that firms with high litigation exposure limit their public disclosures.

Much of the debate about guidance revolves around its effect on the information environment surrounding firms. We addressed these arguments empirically in several ways. For example, we examined the effects of guidance cessation on analyst coverage. Analyst coverage makes a firm better known to investors and the decreased information asymmetry helps generate investors' interest to hold the stock. It is not surprising that 95 percent of the respondents to the NIRI survey believe that one of the benefits of providing guidance is to improve the communication between the firm and its analysts/investors. When we compared the average number of analysts following a company during the pre-event period with that in the post-event period, we found that guidance cessation was associated with a significant decrease in analyst following.

Investors' reactions to earnings announcements are another gauge of the change in the information environment. Other things being equal, the richer a firm's information environment before an earnings announcement, the weaker the investors' reaction to reported earnings should be. So we examined whether the guidance stoppers' earnings-returns relation was different in the post-event period than in the pre-event period. The data indicated that investors responded more strongly to earnings announcements *after* firms stop guidance, which is evidence of a relatively poor information environment post guidance cessation.

Correcting Myopia?

Guidance stoppers and their supporters frequently claim that after guidance cessation, firms provide substitute disclosures about strategy and long-term objectives to mitigate investor myopia. We examine this assertion empirically by collecting and coding stoppers' forward-looking disclosures in quarterly earnings press releases and in the Management, Discussion & Analysis (MD&A) section of the quarterly reports.

We randomly chose 100 stoppers from our stopper sample, and, for each stopper, we randomly chose a fiscal quarter in the post-event period, which we referred to as the "post-quarter." We looked at forward-looking, non-earnings disclosures in nine categories and compared the number of disclosures in the pre- vs. post-quarter. The data show that more stoppers *decreased* forward-looking disclosures than those that increased disclosures: 41 decreased, 29 had no change, and 27 increased. We also found that stoppers curtailed their annual guidance.

Finally, we looked into a major argument of guidance detractors: quarterly guidance focuses managers' attention and decisions on the short-term at the expense of long-term growth. Regulators and trade associations have similarly expressed concerns that quarterly earnings guidance has contributed to managers' myopia. If quarterly guidance indeed increases managers' myopia at the expense of the firm's long-run growth, we should observe an increase in long-term investments, such as capital expenditures and research and development (R&D), once firms stop quarterly guidance and managers are unshackled by the myopic earnings game. To test this assertion, we measured long-term investments by both capital expenditures and R&D intensities -- i.e., deflating the expenditures by the beginning-of-quarter total assets.

Because a firm's long-term investments are likely to vary across industries, we adjusted capital expenditures and R&D in each quarter by the median levels of these investments in a firm's industry. We found that guidance stoppers do not increase their long-term investments after the guidance cessation. This finding, however, may not be generalized to the population of firms not providing guidance. Recall that guidance stoppers are characterized by relatively poor earnings performance in the pre-guidance cessation period and anticipate continuation of poor performance after stopping guidance. Accordingly, the long-term investment opportunities and decisions of these firms may be different from those of the general population of non-guiders.

Next, we considered the flipside of this issue and examined the stoppers that subsequently resumed providing guidance. Among our 222 guidance stoppers, a full 68 firms (30.6 percent) resumed quarterly guidance, according to either the CIG database or our news search in Factiva. The median length of the silent period was six quarters -- a relatively short time for a reversal of a significant change in disclosure policy. To analyze the determinants of guidance resumption, we used a sample of 42 firms as our resumer sample. We found that relative to the non-resumers, the resumers experienced (weakly) a larger decrease in analyst following, a smaller increase in forecast dispersion, a decreasing percentage of loss quarters, and improved earnings in the silent period. Thus, firms that resumed quarterly guidance were by and large affected more severely by the stopping decision.

The debate on guidance is clearly continuing. In June [2007], a coalition of labor unions and CEOs, led by the Aspen Institute, issued a plea for companies to cease giving quarterly guidance. But our investigations show that the concerns surrounding guidance aren't necessarily borne out by activity in the marketplace. Critics may think that guidance has a pernicious influence on the public capital markets -- one that harms investors, doesn't help analysts, and pushes managers into self-defeating, myopic actions. The data tell us otherwise.

Company Description

Infosys is the second-largest IT services company in India providing consulting and IT services to clients globally. It is also among the fastest growing IT services organization in the world and a leader in the offshore services space with a pioneer in Global delivery model. Infosys provides business consulting, application development and maintenance and engineering services to 583 active clients spread across Banking, Financial Services, Insurance, Retail, Manufacturing, and Utilities verticals and 29 countries. The company has also its own proprietary core banking software - Finacle used by some of the leading banks in India, Middle East, Africa and Europe. Infosys' IT services employee force stands at 103,078 and the company's revenues for FY08 stood at INR 166.9 bn (USD 4.2 bn).

Investment Theme

Infosys is known for its excellent project execution skills, which makes it the most preferred tier 1 vendor. With rapidly increasing numbers of service lines and domain capabilities, Infosys has readied itself for multiple possible points of initiating and growing client engagements. The company has also demonstrated its ability to engage with larger client organizations and winning increasing proportion of their wallet share. Infosys' growth over the last three to four years reflect its abilities to benefit from the improving macro environment, as reflected in its above-peer group growth in its offshore revenues, key verticals and service lines.

Key Risks

Key risks to our investment theme include - Slowdown in US, reduction in the number of H1B visas granted by US will have an adverse impact and steep incremental appreciation of rupee against US dollar, Euro and GBP.

Financial Statements

Income statement (INR mn)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Revenues	95,216	138,930	166,920	218,231	219,693
Cost of revenues	50,654	74,580	92,070	117,928	119,165
Gross profit	44,562	64,350	74,850	100,303	100,528
S&M expenses	6,005	9,290	9,160	11,511	12,687
G&A expenses	7,639	11,150	13,310	16,324	15,818
Total SG&A expenses	13,643	20,440	22,470	27,835	28,504
EBITDA	30,918	43,910	52,380	72,468	72,024
Depreciation & amortization	4,371	5,140	5,980	7,232	8,245
EBIT	26,547	38,770	46,400	65,236	63,779
Other income	2,240	3,450	6,920	7,739	6,040
Foreign exchange gain/(loss)	(844)	270	120	(6,064)	(600)
Profit before tax	27,933	42,470	53,440	66,891	69,218
Tax	3,132	3,860	6,850	8,716	12,459
Core profit	24,801	38,610	46,590	58,176	56,759
Profit after tax	24,801	38,610	46,590	58,176	56,759
Net profit after minority interest	24,600	38,500	46,590	58,176	56,759
Shares outstanding (mn)	546	557	571	573	573
EPS (INR) basic	45.1	69.1	81.5	101.6	99.0
Diluted shares (mn)	562	569	573	573	573
EPS (INR) diluted	43.8	67.6	81.3	101.5	99.0
CEPS (INR)	53.3	78.7	92.3	114.5	113.4
Dividend per share	23	12	33	25	28
Dividend (%)	900.0	232.3	665.7	500.0	560.0
Dividend pay out (%)	57.0	19.5	47.8	28.8	33.1

Common size metrics - as % of revenues

Year to March	FY06	FY07	FY08	FY09E	FY10E
Cost of revenues	53.2	53.7	55.2	54.0	54.2
Gross margin	46.8	46.3	44.8	46.0	45.8
G&A expenses	8.0	8.0	8.0	7.5	7.2
S&M expenses	6.3	6.7	5.5	5.3	5.8
SG&A expenses	14.3	14.7	13.5	12.8	13.0
EBITDA margin	32.5	31.6	31.4	33.2	32.8
EBIT margin	27.9	27.9	27.8	29.9	29.0
Net profit margins	26.0	27.8	27.9	26.7	25.8

Growth metrics (%)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Revenues	33.5	45.9	20.1	30.7	0.7
EBITDA	32.4	42.0	19.3	38.4	(0.6)
EBIT	29.6	46.0	19.7	40.6	(2.2)
PBT	28.6	52.0	25.8	25.2	3.5
Net profit	34.3	55.7	20.7	24.9	(2.4)
EPS	30.7	54.4	20.2	24.8	(2.4)

Balance sheet (INR mn)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Equity share capital	1,380	2,860	2,860	2,863	2,866
Share premium account	15,430	27,680	28,510	38,510	48,510
Reserves	52,850	82,010	106,580	148,010	185,990
Total shareholders funds	69,660	112,550	137,950	189,383	237,366
Sources of funds	**70,340**	**112,590**	**137,950**	**189,383**	**237,366**
Goodwill and other intangible asset	410	5,890	6,890	6,890	6,890
Gross fixed assets	29,420	40,530	47,500	60,000	72,500
Less: Accumulated depreciation	13,280	18,360	19,860	27,092	35,338
Net fixed assets	16,140	22,170	27,640	32,908	37,162
Capital WIP	5,710	9,650	13,240	12,290	11,340
Investments	7,550	250	720	1,132	1,811
Deferred tax asset	650	920	1,190	1,190	1,190
Cash & bank balances	34,290	58,340	69,500	118,749	164,025
Debtors	16,080	24,360	32,970	32,334	33,104
Loans and advances	12,970	12,510	27,710	34,638	43,297
Total current assets	63,340	95,210	130,180	185,721	240,426
Sundry creditors	9,340	14,690	19,120	22,944	27,533
Provisions	14,120	6,810	22,790	27,804	33,921
Total current liabilities	23,460	21,500	41,910	50,748	61,453
Working capital	39,880	73,710	88,270	134,973	178,973
Application of funds	**70,340**	**112,590**	**137,950**	**189,383**	**237,366**
Book value per share (BV) (INR)	124	198	241	330	414

Free cash flow

Year to March	FY06	FY07	FY08	FY09E	FY10E
Net profit	24,600	38,500	46,590	58,176	56,759
Depreciation	4,371	5,140	5,980	7,232	8,245
Deferred tax	137	170	150	170	0
Others	(9,654)	1,180	(8,490)	(7,589)	(6,040)
Gross cash flow	19,454	44,990	44,230	57,989	58,964
Less:Changes in working capital	(3,927)	9,780	3,400	(2,546)	(1,276)
Operating cash flow	23,381	35,210	40,830	60,535	60,240
Less: Capex	9,485	15,050	10,560	11,550	11,550
Free cash flow	**13,896**	**20,160**	**30,270**	**48,985**	**48,690**

Cash flow statement (INR mn)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Cash flow from operations	24,581	39,980	46,930	57,989	58,964
Cash for working capital	(1,200)	(4,770)	(6,100)	2,546	1,276
Operating cashflow (A)	23,381	35,210	40,830	60,535	60,240
Net purchase of fixed assets	(10,890)	(21,560)	(15,950)	(11,550)	(11,550)
Net purchase of investments	4,550	7,460	(710)	(412)	(679)
Others	2,110	2,890	5,460	7,419	6,040
Investments cashflow (B)	(4,230)	(11,210)	(11,200)	(4,543)	(6,189)
Dividends	(4,030)	(15,320)	(8,350)	(16,746)	(18,779)
Proceeds from issue of equity	6,460	12,160	580	10,003	10,004
Financing cash flow (C)	2,430	(3,160)	(7,770)	(6,743)	(8,776)
Free cash flow	12,491	13,650	24,880	48,985	48,690
Exchange rate differences (D)	90	(70)	410	0	0
Change in cash (A+B+C) + (D)	**21,671**	**20,770**	**22,270**	**49,249**	**45,276**

Ratios

Year to March	FY06	FY07	FY08	FY09E	FY10E
ROAE (%)	39.7	42.3	37.2	35.5	26.6
ROACE (%)	24.1	21.7	18.6	20.0	15.0
Debtors (days)	57	53	63	55	54
Payable (days)	30	32	37	35	42
Cash conversion cycle	26	22	26	19	12
Current ratio	2.7	4.4	3.1	3.7	3.9
Fixed assets turnover (x)	6.7	7.3	6.7	7.2	6.3
Total asset turnover(x)	0.4	0.4	0.3	0.3	0.3
Equity turnover(x)	1.5	1.5	1.3	1.3	1.0

Valuation parameters

Year to March	FY06	FY07	FY08	FY09E	FY10E
Diluted EPS (INR)	43.8	67.6	81.3	101.5	99.0
Y-o-Y growth (%)	*30.7*	*54.4*	*20.2*	*24.8*	*(2.4)*
CEPS (INR)	53.3	78.7	92.3	114.5	113.4
Diluted P/E (x)	27.3	17.7	14.7	11.8	12.1
Price/BV(x)	9.7	6.1	5.0	3.6	2.9
EV/Revenues (x)	6.4	4.4	3.7	2.6	2.4
EV/EBITDA (x)	19.8	13.9	11.7	7.8	7.2

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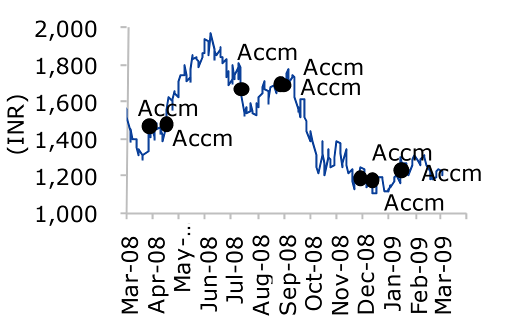
Coverage group(s) of stocks by primary analyst(s): Information Technology

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

Infosys



Recent Research

Date	Company	Title	Price (INR)	Recos
27-Feb-09	**MphasiS**	Riding the slowdown on strong parentage; *Result Update*	168	Buy
17-Feb-09	**Hexaware Technologies**	Escalating business and margin prssures; *Result Update*	31	Sell
13-Feb-09	**Patni Computers**	Worse in store; *Company Update*	110	Sell
10-Feb-09	**Cognizant**	The rise of Cognizant; lessons for Indian IT; *Company Update*	USD 20	

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Accumulate	Reduce	Sell	Total
Rating Distribution*	74	63	30	10	182

* 4 stocks under review / 1 rating withheld

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	68	46	68

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

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