July 8, 2010

IT

ANNUAL REPORT ANALYSIS

Infosys Technologies (Rs2,826)

Market Performer

Target Price: Rs3,025

KARVY STOCK BROKING LIMITED

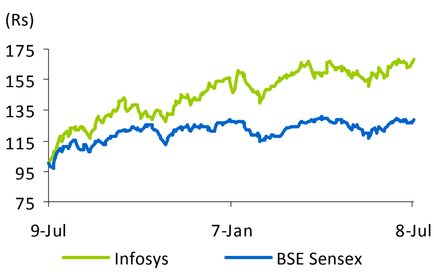
Institutional Equities

India Research

Stock Data

Bloomberg Code	INFO.IN
Market Cap. (Rs bn / US$ bn)	1,621/34.6
52-week High/Low (Rs)	2,875/1,635
Shares Outstanding (mn)	574
Avg. daily volume ('000)	1,325
Avg. daily value (Rs mn)	3,159
Promoter holding (%)	16.0
Free float (%)	84.0
FII holding (%)	55.8

Relative Performance



BSE Sensex	17,652

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Key Highlights

- **Vertical revenue split:** In FY10, it was the retail vertical that recorded the highest growth for Infosys (11.3%), while the key banking, financial services and insurance (BFSI) vertical grew over 5%. The telecom vertical de-grew by 6.3% mainly owing to client-specific issues with British Telecom (BT).
- **Geographic revenue split:** It was the US that drove growth for Infosys in FY10, growing 8%. Unsurprisingly, it was Europe that saw revenues decline over 8% partly owing to client-specific issues in the telecom vertical.
- **HR perspective:** Infosys had 113,796 employees at the end of FY10. Attrition spiked to 13.4% (11.1% in FY09). Higher wage costs will be the major factor likely to pressurise margins in FY11, as hiring takes off.
- **A 'taxing' issue:** Infosys' tax rate rose to 21.3% in FY10 from 13.3% in FY09 owing to the expiry of tax benefits for 5 of its STP facilities. In FY11, 80% of Infosys' revenues will be subject to full tax. We estimate 24% tax in FY11.
- **Geographic and vertical expansion:** Infosys in FY10 incorporated subsidiaries in new geographies, namely Sweden and Brazil. The IT major also incorporated a subsidiary to tap the government sector.
- **Cash and bank balances - differing perceptions of risk over the years:** Infosys in FY10 saw a reduction in the proportion of its scheduled bank deposits with PSU banks. Infosys had significantly increased its deposits with PSU banks in FY09 during the recession owing to their lower risk perception. With the global recovery and a return of risk appetite, Infosys increased its share of deposits with private banks in FY10 to 24% (17% in FY09).

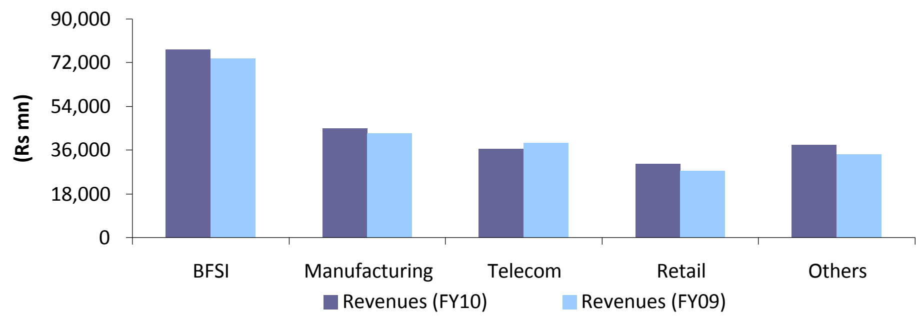
Y/E March (Rs mn)	FY2008	FY2009	FY2010	FY2011E	FY2012E
Net Sales	166,920	216,930	227,420	264,261	311,121
EBITDA	52,380	71,950	78,610	89,584	104,226
Net Profit	46,590	59,880	62,660	70,184	78,888
EPS (Rs)	81.2	104.4	109.2	122.3	137.5
EPS Growth (%)	20.8	28.5	4.6	12.0	12.4
EBITDA margin (%)	31.4	33.2	34.6	33.9	33.5
PER (x)	34.8	27.1	25.9	23.1	20.6
P/BV (x)	11.6	8.7	6.9	5.7	4.8
Price/sales (x)	9.6	7.4	7.0	6.0	5.1
EV/EBITDA (x)	29.6	21.2	19.3	16.5	13.7
ROE (%)	37.2	37.4	30.3	27.5	25.6
ROCE (%)	37.2	37.4	30.1	27.5	25.6

Source: Company and Karvy Institutional Research

FY10 Annual Report Analysis

Vertical revenue split: In FY10, it was the retail vertical that recorded the highest growth for Infosys (11.3%) to Rs 30.4 bn (US$ 641 mn), while the key banking, financial services and insurance (BFSI) vertical grew over 5% to Rs 77.3 bn (US$ 1,633 mn). The telecom vertical de-grew by 6.3% to Rs 36.6 bn (US$ 773 mn) mainly owing to client-specific issues with British Telecom (BT), its largest telecom client. Manufacturing clocked a 5.1% growth to Rs 45.1 bn (US$ 952 mn).

Exhibit 1: Infosys FY10 vertical break-up



Source: Infosys Annual Report 2009-10

While it was the retail vertical that recorded the highest growth in FY10 for Infosys, it was the recovery in the BFSI vertical that was the major positive given that this vertical contributes nearly 35% to the IT major's revenues. BFSI contributed nearly 40% to the company's incremental revenues during the fiscal driven by M&A integration work in the US. We believe the telecom vertical has stabilised and going ahead it is not expected to witness a major fall even as significant growth may not occur given the turmoil currently being witnessed in Europe (BT, Infosys' largest telecom client is UK-based) and the company-specific issues being witnessed at BT itself. We expect BFSI to remain the key vertical going forward, with emerging verticals like retail providing a further thrust enabling vertical diversification and reduced dependence on BFSI.

Vertical profitability: In FY10, it was the telecom and BFSI verticals that recorded the highest profitability, with EBITDA margins of 39.6% and 35.1%, respectively (company average 34.6%). This implies an increase of 272 bps and 279 bps, respectively over FY09 (140 bps overall margin expansion). The higher margins in these verticals are a likely indication of their relative maturity and stability for Infosys. The IT major's largest clients come primarily from these verticals and the percentage of repeat business is typically high, thus leading to lower selling and marketing costs to service them. EBIDTA margins in the retail vertical also expanded by 122 bps to 33.8%.

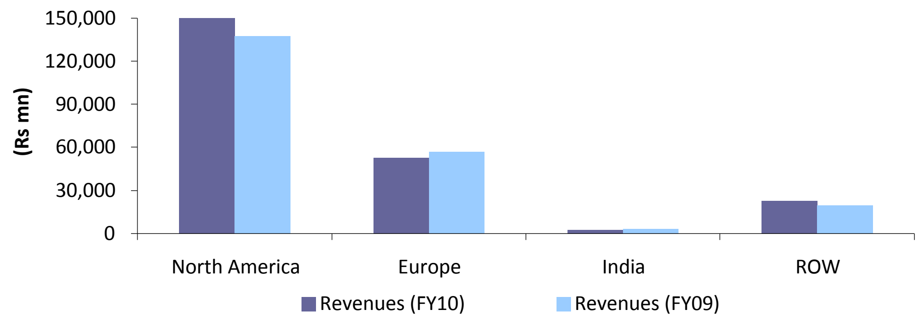
Exhibit 2: Vertical-wise EBITDA margins

Vertical	BFSI	Mfg.	Telecom	Retail	Others	Total
EBITDA (Rs mn, FY10)	27,100	13,740	14,510	10,250	13,010	**78,610**
EBITDA (Rs mn, FY09)	23,740	13,260	14,420	8,880	11,650	**71,950**
% growth	*14.2*	*3.6*	*0.6*	*15.4*	*11.7*	***9.3***
Operating Margins (%, FY10)	35.1	30.5	39.6	33.8	34.2	**34.6**
Operating Margins (%, FY09)	32.3	30.9	36.9	32.6	34.1	**33.2**
% chg	*2.8*	*(0.4)*	*2.7*	*1.2*	*0.0*	***1.4***

Source: Infosys Annual Report 2009-10

Geographic revenue split: It was the key US geography that drove growth for Infosys in FY10. The US grew 8% to Rs 141.7 bn (nearly US$ 3 bn) in revenue contributing 120% to the IT major's incremental growth thus implying that the other geographies recorded revenue declines on a combined basis. Unsurprisingly, it was the European geography that saw revenues decline over 8% to Rs 46.3 bn (US$ 978 mn), which was mainly owing to client-specific issues witnessed at BT in the telecom vertical. India and Rest of the World grew 3.5% and 13.6%, respectively.

Exhibit 3: Infosys FY10 geographical break-up



Source: Infosys Annual Report 2009-10

We believe going forward it will be the US geography that will drive growth for Infosys, as Europe battles with a debt crisis and increased uncertainty about the Euro. Even as so far there has not been any major impact of the European crisis on business volumes given negligible exposure to the economies impacted (PIIGS), this is a factor that we will keep a close watch on particularly in the event of the crisis worsening. The exposure of key clients to these economies is a factor that we believe should be tracked as in the event of the crisis worsening, it could have a bearing on IT budgets of these clients. We believe it is likely, given the crisis that the Euro as a currency will weaken against the US Dollar. This will have a negative impact on reported dollar numbers given that the IT major bills around 7% of its revenues in Euros. Consequently, we believe currency fluctuations are the immediate concern for Infosys while over a longer-term time frame if the crisis were to worsen the impact on business volumes needs to be gauged.

Exhibit 4: Infosys currency-wise revenue basket

Currency (% of revenues)	FY09	FY10
US Dollar (USD)	72.3	74.4
British Pound (GBP)	11.8	8.5
Euro (EUR)	6.9	6.7
Australian Dollar (AUD)	4.4	5.8
Others	4.6	4.6
Total	**100.0**	**100.0**

Source: Infosys Annual Report 2009-10

Geographic profitability: In FY10, the major US and European geographies clocked strong expansion in EBITDA margins of 220 bps and 118 bps, respectively over FY09 (34.2% EBITDA margins in the US, 34.7% in Europe), as Infosys focussed more on enhancing profitability in a year of challenging business conditions. India however saw a decline of 622 bps in margins, which fell to 45.2% (51.4% in FY09). It should be noted that even though margins in India are quite high, the business is very small in size (1.2% of total revenues) and thus do not have a meaningful bearing on overall margins. We also believe as the business grows in size, margins will stabilise at the company average level.

Exhibit 5: Geography-wise EBITDA margins

Vertical	BFSI	Mfg.	Telecom	Retail	Total
EBITDA (Rs mn, FY10)	51,210	18,190	1,220	7,990	**78,610**
EBITDA (Rs mn, FY09)	43,960	19,140	1,460	7,390	**71,950**
% growth	*16.5*	*(5.0)*	*(16.4)*	*8.1*	***9.3***
Operating Margins (%, FY10)	34.2	34.7	45.2	35.3	**34.6**
Operating Margins (%, FY09)	32.0	33.5	51.4	37.6	**33.2**
% chg	*2.2*	*1.2*	*(6.2)*	*(2.2)*	***1.4***

Source: Infosys Annual Report 2009-10

HR perspective: Infosys had a total of 113,796 employees at the end of FY10, with 106,864 software professionals (including banking product group and trainees) and 6,932 sales and support employees. For the full year, the IT major hired 27,639 employees on a gross basis (8,946 net). Attrition spiked to 13.4% as compared with 11.1% in FY09.

We expect Infosys to recruit over 30,000 employees on a gross basis in FY11 even as the company still has room to increase its utilisation rate (74.4% excluding trainees in FY10). An increase in wage costs will be the major factor that is likely to pressurise margins in FY11, as the industry returns to growth and hiring takes off. We expect attrition rates to inch further up as well and expect this to be a key issue facing the IT industry in general and Infosys in particular. We believe increasing utilisation rates will be the key lever to manage margins in FY11.

A 'taxing' issue: Infosys' tax rate rose to 21.3% in FY10 from 13.3% in FY09 owing to the expiry of the tax benefits under the STPI scheme for 5 of its STP facilities - Phase II, Electronics City (Bangalore), Hinjewadi (Pune), Mysore, Hyderabad and Chandigarh. In FY11 and beyond, the IT major's tax rates are expected to continue to inch further up going forward. Only one of the company's STP facilities is eligible for claiming STPI benefits in FY11 (Thiruvananthapuram) post which the STPI benefits expire.

In FY10, just 13% of the IT major's revenues came from STP units under tax holidays (82% in FY09), while 17% came from its locations in Special Economic Zones (SEZs, 11% in FY09). Thus, 70% of Infosys' revenues were subject to full tax in India (vis-à-vis just 7% in FY09) on account of 5 STP units coming out of the tax holiday, which accounted for a lion's share of the company's revenues. In FY11, the last STP unit of Thiruvananthapuram will be eligible for tax benefits post which all STP units of Infosys will be subject to full tax. A significant proportion of incremental revenues will come from the company's SEZ units (5 units set up as on March 31, 2010 - Mahindra City, Chennai, Chandigarh, Mangalore, Pune and Thiruvananthapuram). However, given that a lion's share of revenues comes from the IT major's STPI units, its tax rates are expected to continue to rise. In FY11, 80% of Infosys' revenues will be subject to full tax. We estimate a 24% tax rate in FY11 and 26% in FY12.

Geographic and vertical expansion, M&A transactions: Infosys in FY10 incorporated 3 subsidiaries - Infosys Technologies (Sweden) AB, Infosys Tecnologia DO Brasil LTDA (total investments of Rs 180 mn) and Infosys Public Services Inc. (total investments of Rs 240 mn). Infosys Consulting, a 100% subsidiary of Infosys Technologies (total investments Rs 2.4 bn) also set up a wholly-owned subsidiary, Infosys Consulting India Limited, investing a sum of Rs 10 mn until March 31, 2020.

On the M&A front, Infosys BPO, a 99.98% subsidiary of the IT major acquired 100% stake in McCamish Systems LLC, a BPO company based out of Atlanta, Georgia in the US. The cash consideration paid for the transaction was Rs 1.7 bn (US$ 38 mn) and contingent consideration of Rs 670 mn. On account of the acquisition, additional goodwill of Rs 2.3 bn was created, thus leading to an increase in goodwill in the balance sheet from Rs 6.9 bn to Rs 9.2 bn.

We believe the company's initiatives to expand into newer geographies are steps in the right direction, as they will enable it to service a larger market as well as provide more options to its clients in terms of project execution from newer locations. This also has the advantage of providing a 'near-shore option' to clients based in these geographies. This applies particularly to first-time outsourcers who might not be comfortable with offshoring their IT functions to low-cost destinations like India and would prefer to 'test the waters' first by getting their IT function executed from a location closer to home.

Infosys' initiatives to set up an India-based consulting arm and a public services unit also indicates its intentions to more meaningfully grow its India business (just Rs 2.7 bn revenue in FY10, 1.2% of total consolidated revenues) and its public sector business, such as work from major governments like the US and UK. The acquisition of McCamish Systems will also enable Infosys to focus more earning more revenues from non-linear business initiatives. McCamish provides solutions to the insurance and financial services industries leveraging its proprietary platforms, which support both traditional and non-traditional life insurance and annuities.

A highly liquid balance sheet, but returns on cash low: Infosys at the end of FY10 had a significant Rs 130.7 bn (US$ 2.8 bn) in cash/bank balances and liquid mutual fund units. This accounts for 56% of its balance sheet size, implying the strong cash generating ability of the firm. However, it should be noted that such significant cash generation, the lack of major initiatives on the acquisition front apart from McCamish, no special dividend paid out in FY10 and the company's conservative policy of keeping cash equal to a year's expenses has led to a large portion of its cash being invested in safe but low-yielding bank deposits and liquid mutual fund units. Infosys earned Rs 7.8 bn as interest on deposits with banks in FY10, implying returns of 8.5%, much lower than cost of capital.

Infosys' debtor days for FY10 stood at 56 as compared with 62 in FY09, thus implying a strong focus on collections amidst a challenging business environment. In fact, even as revenues recorded low single digit growth, debtors in absolute terms actually declined from Rs 36.7 bn to Rs 34.9 bn. Infosys remains a debt-free company.

Capex: Infosys spent Rs 6.8 bn (US$ 143 mn) on capex in FY10 (3% of revenues), a steep fall from Rs 13.3 bn (US$ 285 mn) in FY09 (6% of revenues) on account of the global recession and subsequent slowdown in order flows from clients. The IT major also invested Rs 1.7 bn (US$ 37 mn) on the acquisition of McCamish Systems. Including this, total capex for FY10 was Rs 8.5 bn (US$ 179 mn, 3.7% of revenues). The entire capex plan was funded through internal accruals.

Cash and bank balances - differing perceptions of risk over the years: Infosys in FY10 saw a reduction in the proportion of its scheduled bank deposit balances with public sector banks (76% of the total v/s 83% in FY09). However, a lion's share of the IT major's bank deposits still sits with these banks (Rs 69.4 bn). Of this, the maximum amount was deposited with Canara Bank, Punjab National Bank (PNB), IDBI Bank, Bank of India, Bank of Maharashtra, State Bank of Mysore and Syndicate Bank. It may be noted that with the global economy undergoing significant pain in FY09, Infosys had significantly increased its deposits with PSU banks during the fiscal owing to their lower risk perception. The percentage of total scheduled bank deposits with PSU banks surged from 59% in FY08 to as much as 83% in FY09. However, with the global recovery and improvement in risk appetite, Infosys increased its share of deposits with private sector banks in FY10 to 24% after a steep fall to 17% in FY09 (as much as 41% in FY08).

Exhibit 6: Cash and bank balances - A slight shift back to private sector banks in FY10

Particulars (Rs mn)	FY08	FY09	FY10
Private Sector Banks			
Axis Bank	2,500	0	0
Barclays Bank	3,000	1,400	1,000
DBS Bank	0	250	490
HDFC Bank	4,500	0	0
HSBC Bank	2,500	2,830	4,830
ICICI Bank	10,250	5,600	14,350
ING Vysya Bank	200	530	250
Kotak Mahindra Bank	0	0	610
Standard Chartered Bank	0	380	0
The Bank of Nova Scotia	1,500	3,500	0
Total	**24,450**	**14,490**	**21,530**
% of total deposits with scheduled banks	***41.3***	***16.9***	***23.7***
Public Sector Banks			
Allahabad Bank	0	0	1,500
Andhra Bank	0	800	990
Bank of Baroda	5,000	8,290	2,990
Bank of India	5,000	0	8,810
Bank of Maharashtra	3,870	5,370	5,000
Canara Bank	1,150	7,940	9,630
Central Bank of India	0	0	1,000
Corporation Bank	4,400	3,430	2,760
IDBI Bank	5,000	5,500	9,090
Indian Overseas Bank	0	0	1,400
Jammu & Kashmir Bank	0	0	100
Oriental Bank of Commerce	0	0	1,000
Punjab National Bank	250	4,800	9,940
State Bank of Hyderabad	0	2,000	2,330
State Bank of India	10,010	21,090	1,260
State Bank of Mysore	0	5,000	4,960
Syndicate Bank	0	5,000	4,750
Union Bank of India	0	850	930
Vijaya Bank	0	950	950
Total	**34,680**	**71,020**	**69,390**
% of total deposits with scheduled banks	***58.7***	***83.1***	***76.3***
Total deposits with scheduled banks	**59,130**	**85,510**	**90,920**

Source: Infosys Annual Reports 2008-09 and 2009-10

An interesting trend has been observed with reference to the share of private sector banks in Infosys' total deposits. Two major banks and financial institutions - ICICI Bank and HDFC Limited hold nearly Rs 30 bn worth of deposits from the IT major. Apart from the Rs 14.4 bn deposited with ICICI Bank, Infosys has also deposited Rs 15.5 bn with HDFC Limited. Incidentally, the Chairman of ICICI Bank, Mr. K.V. Kamath and a director on the board of HDFC Limited, Mr. Deepak Satwalekar are both independent directors on the board of Infosys. The company has clearly disclosed in Schedule 24.2.9 to the consolidated financial statements that Mr. Satwalekar is a director of HDFC Limited and has no direct interest in any transactions.

Operating metric and ratio analysis: Infosys' average revenues per employee stood at Rs 2.1 mn (US$ 44,000) in FY10, a 6% decline as compared with FY09 (Rs 2.2 mn, US$ 47,600). This was on account of the company fulfilling its hiring commitments in spite of the slowdown in revenues. Thus, even as the company hired a gross of 27,639 and net of 8,946 employees, revenue growth was not proportionate to the increase in employee base.

In terms of ratios, Infosys' return on equity (RoE) stood at a healthy 30.1% during the year (excluding one-time items), while return on capital employed (RoCE) also stood at 30.1%. The company's RoE and RoCE are the same given that it is a debt-free company and PBIT adjusted for taxes is equal to profit after tax. The strong return ratios of the company reflect an ability to generate returns significantly above the cost of capital for shareholders, which stands at around 13.2% assuming a risk-free rate of 8%, market risk premium of 7% and beta of 0.75.

Cash Flow Analysis: Infosys recorded a healthy Rs 62 bn as cash from operations (CFO) in FY10, which is around 27% of revenues (Rs 53.3 bn in FY09, 24.5% of revenues). The key drivers for the improvement in CFO were higher profit before taxation (up 14%), depreciation (up 19%), positive exchange differences (positive Rs 850 mn v/s negative Rs 1.05 bn) and lower debtor position owing to improved collection efforts (debtors lower by Rs 1.9 bn v/s increase of Rs 3.8 bn). The company was able to comfortably meet its capex commitments, pay for acquisitions, income taxes and dividends through its CFO and invested the balance in liquid mutual funds (Rs 37 bn net).

Exhibit 7: Cash Flow Statement - Strong CFO

Particulars (Rs mn)	FY09	FY10
Profit before tax	69,070	78,990
Depreciation	7,610	9,050
Interest and dividends paid	(8,760)	(8,810)
Forex effect	(1,050)	850
Others	0	(110)
Working capital changes	(4,600)	(400)
Income taxes paid	(9,020)	(17,530)
Net cash from operations	**53,250**	**62,040**
% of sales	***24.5***	***27.3***
Capex	(13,270)	(6,750)
Acquisitions	(100)	(1,730)
Others	(60)	0
Cash from investing activities	**(13,430)**	**(8,480)**
Issue of capital from exercise of ESOPs	640	890
Investments in securities	720	(36,980)
Interest and dividends received	10,560	8,710
Dividends paid	(21,310)	(13,460)
Dividend tax paid	(3,630)	(2,280)
Others	780	740
Cash from financing activities	**(12,240)**	**(42,380)**
Net change in cash and cash equivalents	**27,580**	**11,180**
Cash and cash equivalents at the beginning of the year	82,350	109,930
Cash and cash equivalents at the end of the year	**109,930**	**121,110**

Source: Infosys Annual Report 2009-10

Outlook and Valuation

Infosys has recorded a creditable performance in FY10 in the face of significant headwinds to growth. The company has been able to enhance profitability as well through judicious cost control measures. Its balance sheet remains highly liquid and its return on equity and capital are well above its cost of capital, even as returns on the significant cash balance held by it remain low at 8%. The IT major remains a debt-free company. We forecast 20.5% volume growth, 23.6% dollar revenue growth and 16.2% rupee revenue growth in FY11. We believe investors should take note of significant currency fluctuations witnessed of late. The European crisis is also another factor to keep a close watch on, apart from the risk of a double dip recession in the US.

We expect Infosys to record a 17% CAGR in top-line and 12% CAGR in bottom-line over FY10-12E. At Rs 2,826, Infosys' stock is trading at 20.6x FY12E EPS. **We maintain a 'Market performer' rating on the stock owing to high valuations. We maintain our target price of Rs 3,025. We arrive at our target price by assigning a 22x P/E multiple to Infosys' FY12E EPS.**

Stock Ratings		Absolute Returns
Buy	:	> 25%
Out Performer	:	16 - 25%
Market Performer	:	0 - 15%
Under Performer	:	< 0%
Sell	:	<(25%)

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Disclosures Appendix

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