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INDIA RESEARCH | IT SERVICES | BSE SENSEX: 18439 | MARCH 14, 2011

# Infosys Technologies

## MANAGEMENT MEETING NOTE

**OUTPERFORMER**

Rs3,101

Mkt Cap: Rs1.78tn; US$40bn

We recently met the management of Infosys Technologies (Infosys). The management is confident of a better CY11 vis-à-vis CY10 based on a healthy demand environment in the US – a key geography. While a sluggish and uneven recovery in Europe as also the ongoing crisis in Middle East do cast a shadow in the near term, the longer term outlook remains bullish. Discretionary spends, hitherto restricted to BFSI, are returning in other verticals (Retail/ CPG, Energy & Utilities, Pharma/ Healthcare) as well. While FY12 guidance is some time away, we expect the management to conservatively guide to ~18% revenue growth. On the supply side, attrition remains high but ~26,000 campus offers for FY12 (as also lateral hires in both India and abroad) reflect the management's comfort on future growth prospects and its grip on supply side dynamics. Further, the management expects margins to be stable in FY11 after ~100bp correction in FY11 (in line with industry; margins had improved ~260bp over FY08-10). At ~21x FY12E earnings, we reiterate Outperformer on the stock with a 12-month price target of Rs3,900. We maintain Infosys among our top picks in the sector.

### Key financials

| As on 31 March | FY09 | FY10 | FY11E | FY12E | FY13E |
|---|---|---|---|---|---|
| Net sales (Rs m) | 216,930 | 227,420 | 275,981 | 329,150 | 391,403 |
| Adj. net profit (Rs m) | 59,750 | 62,190 | 69,019 | 85,522 | 106,038 |
| Shares in issue (m) | 573 | 571 | 571 | 571 | 571 |
| Adj. EPS (Rs) | 104.6 | 109.0 | 120.8 | 149.7 | 185.6 |
| *% change* | *28.3* | *4.2* | *10.8* | *23.9* | *24.0* |
| PE (x) | 29.6 | 28.4 | 25.7 | 20.7 | 16.7 |
| Price/ Book (x) | 9.2 | 7.3 | 6.7 | 5.3 | 4.2 |
| EV/ EBITDA (x) | 23.1 | 20.6 | 17.6 | 14.2 | 11.4 |
| RoE (%) | 36.2 | 28.7 | 27.3 | 28.5 | 28.1 |
| RoCE (%) | 38.6 | 31.5 | 32.1 | 32.9 | 31.2 |

*Source: IDFC Securities Research*

### Demand environment remains strong…

According to Infosys management, an improving macroeconomic environment in key global markets is boosting demand. Demand growth is largely US-driven, while some challenges persist in Europe. Nevertheless, Infosys remains cautious in the near term because of the ongoing Middle East crisis. While it does not have any significant direct exposure to the region, it may have indirect exposure from its clients' business perspective. If the crisis spreads or continues for long, that could hurt the overall business sentiment, and hence IT spends, in the short term. Though the management does not see any change in total CY11 IT budgets, it believes that clients may go slow on spend in the near term in response to the economic changes. In the long term, Infosys is confident of sustained robust demand.

Infosys has yet to complete its budgeting cycle and, hence, guidance for FY12 is still some time away. We expect the management to guide to ~18% revenue growth for FY12. In April 2010, the company had guided to 16-18% revenue growth – upgraded thrice (usual ***beat-and-raise*** track record of Infosys) to ~26% revenue growth.

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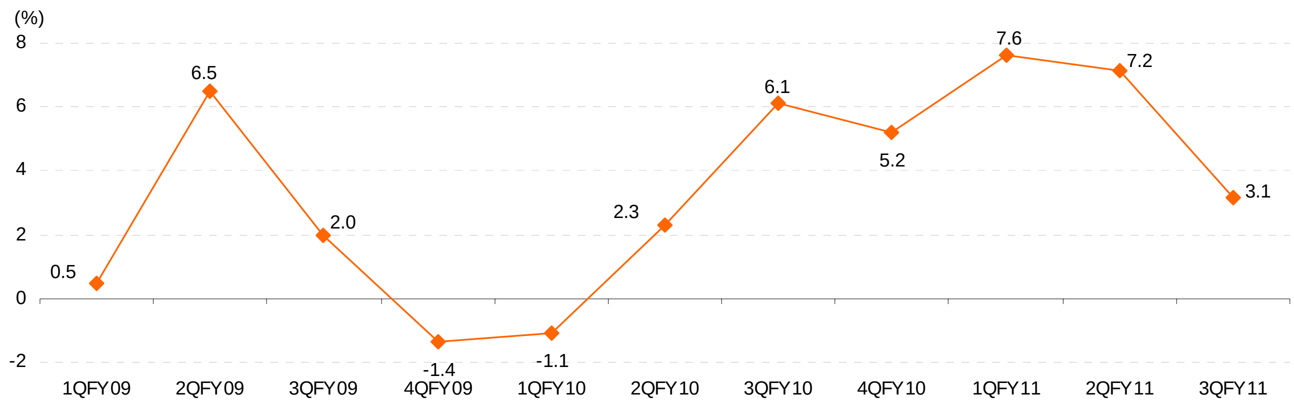
Exhibit 1: Infosys – sequential volume growth

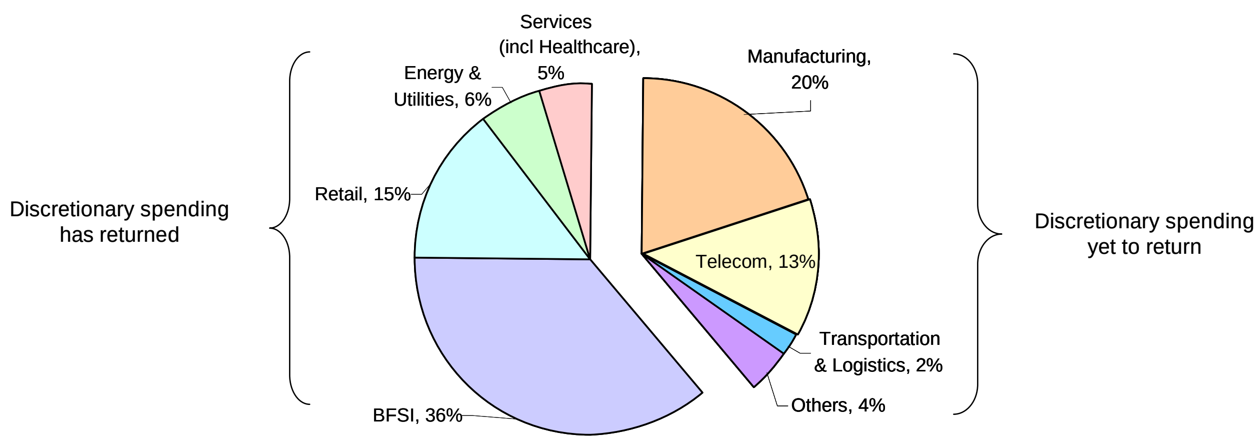



*Source: Company, IDFC Securities Research*

## …with discretionary spend returning in majority of business segments

The management expects CY11 to be better than CY10 as discretionary spending returns across major business segments. According to the management, CY10 was a year of release in pent-up demand in BFSI while CY11 will be marked by return of discretionary spending across majority of business segments. In the retail/ CPG vertical, companies are expanding globally, and need software and services around enhancing internal efficiency (like inventory management) and gaining better understanding of customers. In the healthcare and pharmaceuticals vertical, companies' focus has realigned from "payers" to "providers" of healthcare services. Increased spending in the utilities vertical is marked by clients' need to modernize their systems. The manufacturing vertical is expected to remain steady with an all-round growth. Telecom would, however, remain sluggish and is unlikely to show any signs of recovery till 2HCY11. In the ES/ Consulting service line, the management has indicated bounce-back of discretionary spending and that clients are increasingly demanding cost-effective solutions with offshoring as their top-of-the-mind recall.

Exhibit 2: Return in discretionary spending across majority of Infosys's business segments




*Source: Company, IDFC Securities Research*

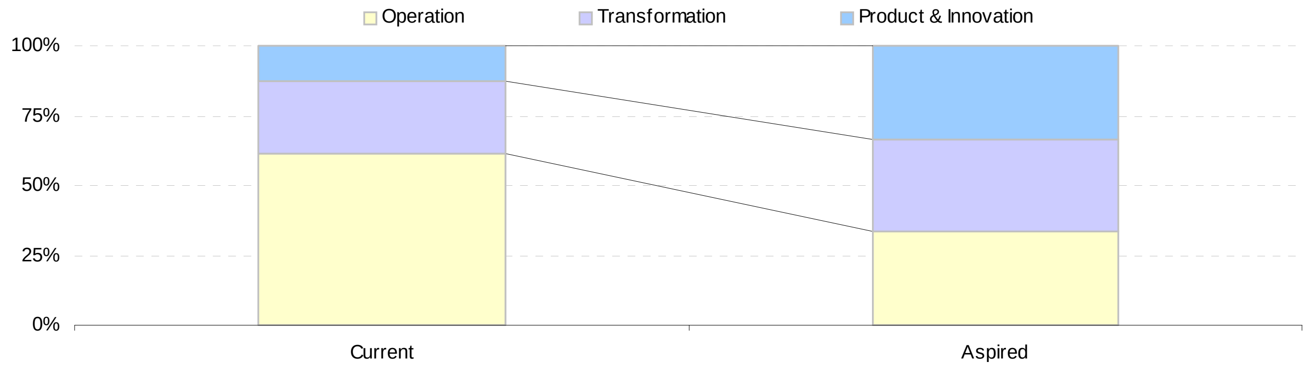
## An improving pricing environment

According to Infosys, pricing environment is better than that in the past few years. After declining by ~4% in FY10, blended realization for Infosys has improved by 2.6% over the last three quarters. The company expects pricing to remain stable with a positive bias in the coming quarters as contractual increments come through and new clients/ business are coming at better price points. The COLA-based price increases, which took a pause during the financial crisis, have resumed. The company's increased focus on new engagement models is also expected to boost realizations in the long term.

## New engagement model – the way to future

During its December 2009 Analyst Meet, Infosys management had articulated its strategic objective to achieve equal revenue contribution from each of the three businesses – transformation, operations, and product & innovation - by FY15. The company is on track to achieve the objective and is focusing on increasing the non-linear revenue share by engaging in new models like financial products (such as Finacle), investments in platform-based BPO and IP creation (Flypp, ShoppingTrip360, etc). Notably, contribution from new engagement models has already increased to 12-13% currently from 5-6% in H1FY10.

Exhibit 3: Future business model of Infosys

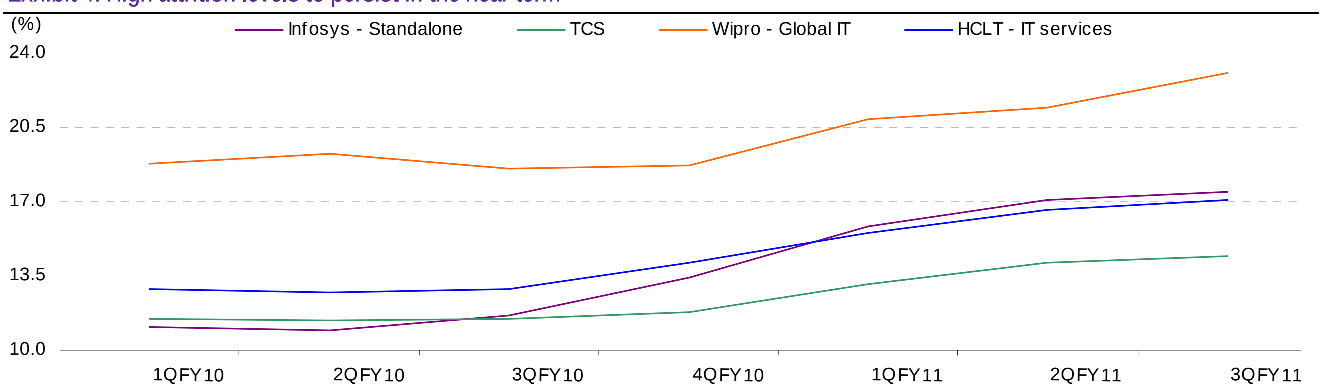



*Source: Company, IDFC Securities Research*

## Supply-side issues are manageable

Employee churn continues to be high (especially in 2-5 years experience band) but Infosys is in a comfortable position to manage the same. The attrition rate, though high, is easing on a sequential basis even as TTM (trailing 12 months) attrition would remain high for a few more quarters. Hiring remains robust with 26,000 campus offers for FY12 given during the past few months. Lateral hiring continues on a selective basis in both India and overseas geographies. Infosys is also strengthening its consulting team and has hired ~1,000 people from B-school campuses across India and a few senior consulting personnel from abroad.

Exhibit 4: High attrition levels to persist in the near term



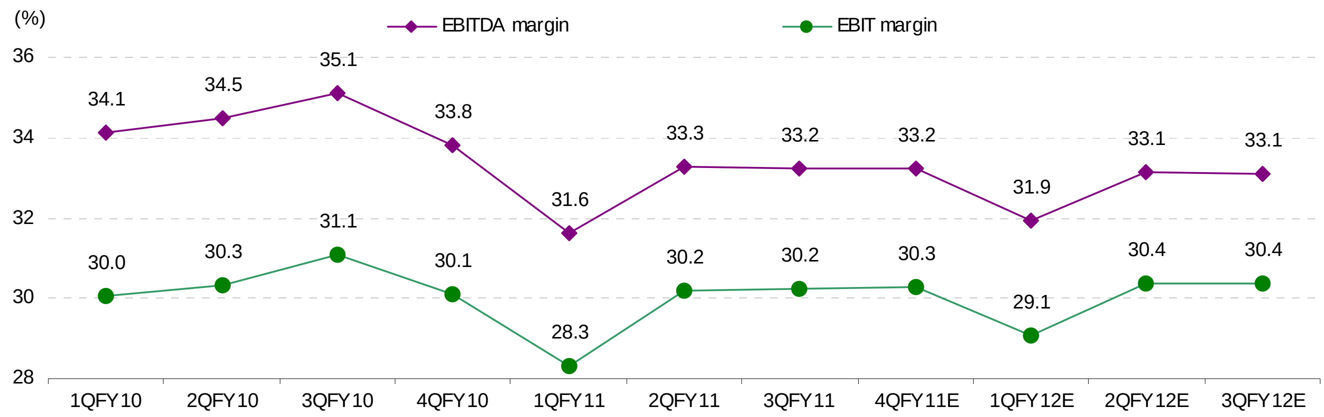

*Source: Company, IDFC Securities Research*

Infosys plans to dole out wage hikes starting April 2011 (the normal wage revision cycle) for both offshore and onsite employees. While the exact quantum of wage hikes has not yet been finalized, we expect a 2-3% raise for onsite employees and in mid-teens for offshore employees – in line with the industry wage hikes.

## Margins to remain range-bound

All tier1 IT services companies have managed to improve margins during the downturn (EBIT margins for Infosys up to 30.4% in FY10 from 27.8% in FY08). However, with return of demand and, hence, associated investments/ supply pressures, margins have normalized. Infosys has guided to ~100bp decline in EBIT margin in FY11. On quarterly basis, EBIT and EBITDA margins have remained steady at ~30% and ~33% respectively. The management expects margins to remain range-bound in the near term with usual seasonality around wage hikes. In the longer term, the management is confident of maintaining the best margin within the industry as it tracks industry trends.

Exhibit 5: Operating margins likely to remain under pressure in the near term

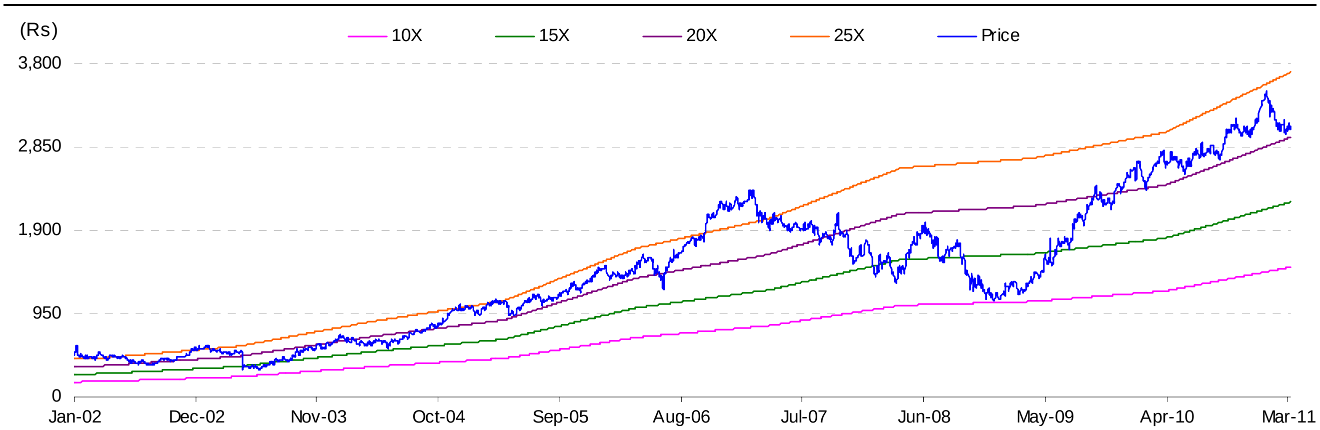



*Source: Company, IDFC Securities Research*

## Valuations and view

At Rs3,101, Infosys stock trades at ~21x FY12E earnings – closer to its historic mean levels. Stock returns from here, we believe, would largely be a function of earnings growth and a gradual re-rating towards ~23x 12-month forward earnings. We maintain Outperformer on Infosys with a 12-month price target of Rs3,900 per share (based on 23x average FY12E and FY13E EPS).

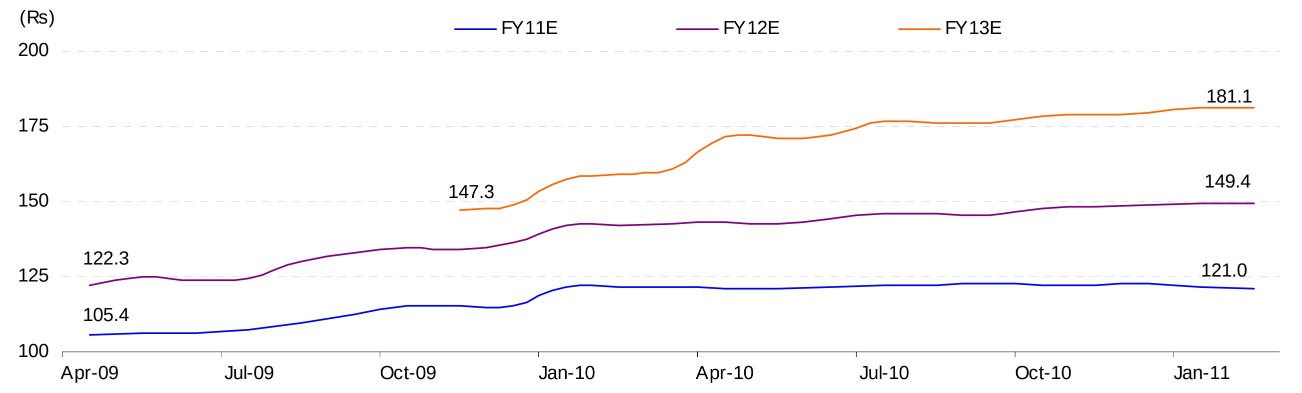
Exhibit 6: Infosys – 12-month forward PER band chart




*Source: Company, Bloomberg, IDFC Securities Research*

Over the last 12 months, street EPS estimates for Infosys have seen ~5% upgrade for FY12 and ~14% upgrade for FY13. On PER re-rating, the stock continued to see gradual re-rating from ~20x 12M forward to ~21x 12M forward. Going forward, we see limited scope for further earnings upgrades but stock returns would track earnings growth.

Exhibit 7: Infosys' earnings upgrade cycle




*Source: Bloomberg consensus estimates*

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**Explanation of Ratings:**

1. Outperformer: More than 5% upside to Index
2. Neutral: Within 0-5% to Index (upside or downside)
3. Underperformer: More than 5% downside to Index

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