Update

SECTOR: INFORMATION TECHNOLOGY

Infosys Technologies

STOCK INFO.	BLOOMBERG
BSE Sensex: 10,787	INFO IN
	REUTERS CODE
S&P CNX: 3,185	INFY.BO

Equity Shares (m)	275.6
52-Week Range	3,400/2122
1,6,12 Rel. Perf. (%)	6/-10/-26
M.Cap. (Rs b)	834.3
M.Cap. (US$ b)	18.1

30 May 2006

Buy

Previous Recommendation: Buy

Rs3,028

YEAR END	NET SALES (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
3/06A	95,216	24,583	89.3	29.4	33.9	12.0	40.3	45.2	8.2	25.3
3/07E	127,775	33,073	120.0	34.4	25.2	8.7	40.0	45.2	6.1	19.0
3/08E	162,409	41,141	149.3	24.4	20.3	6.5	36.8	41.9	4.6	14.5

Infosys is our preferred bet in the IT sector, underpinned by its various long-term initiatives to overcome supply-side issues and expected increase in high-margin business from Europe. With the recent correction in stock price, we believe that risk-reward is more favorable and reiterate our Buy recommendation.

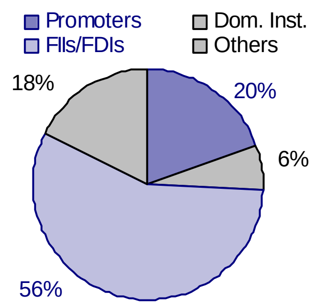
Tackling supply side issues: (1) Besides the usual pool of engineering graduates, the company is evaluating the option to hire normal graduates and train them intensively; (2) strengthen training infrastructure – create a competitive edge; and (3) recruit internationally – to increase the available pool.

Taking concrete steps to expand margins: (1) Move from monthly billing to hourly billing, to enable levy of overtime charges etc.; (2) sell non-AMD services outside the purview of the MSA (master services agreement), as these services can attract higher rates; (3) bid for big-ticket size orders on fixed price basis to reduce margin pressures going forward.

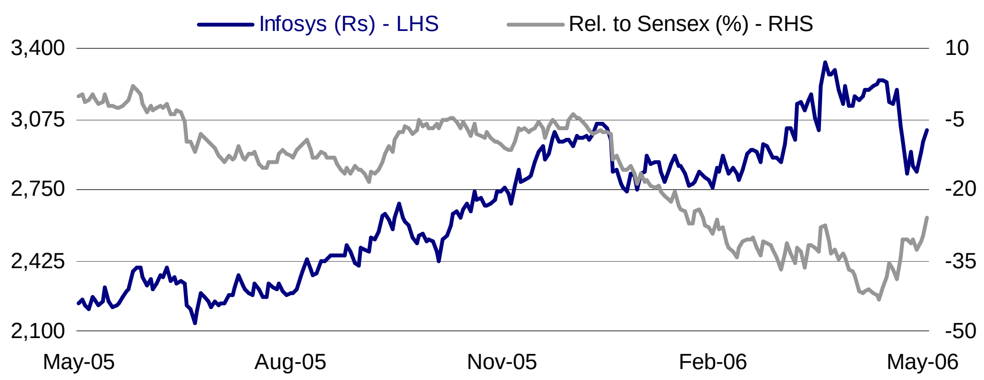
Demand continues to be robust: (1) Higher margins in Europe to continue for a further 2-3 years; (2) increased number of request for proposals (RFPs) being floated v/s a year ago indicating higher traction for offshore services; and (3) apart from BFSI, Telecom, the company expects good growth from Utilities, Energy, Retail and Healthcare segments.

Valuations attractive: In the past one month, the stock has corrected by almost 14.3% and we believe that the current price does not fully reflect the stated margin positives. We believe the current price decline should be used as a Buying opportunity. At CMP of Rs3,028, the stock trades at 25.2x FY07E and 20.3x FY08E. We maintain **Buy** with a target price of Rs3,730 – upside of 23.2%.

SHAREHOLDING PATTERN (%)



STOCK PERFORMANCE (1 YEAR)



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Infosys is our preferred bet in the IT sector, underpinned by its various long-term initiatives to overcome supply-side issues and expected increase in high-margin business from Europe. With the recent correction in stock price, we believe that risk-reward is favorable, considering our expectation of better earnings visibility.

Tackling supply side issues

HR issues remain the single most important challenge. The company is taking the following measures to ensure that it has sufficient trained manpower to sustain its growing business.

- **Besides the usual pool of engineering graduates, Infosys is evaluating the option of hiring non-engineering graduates and training them more intensively:** Infosys is evaluating the option to recruit fresh graduates besides engineering graduates in order to increase the available pool of employees. Currently the annual graduate pool in India is around 3m-4m v/s the engineering graduate pool of merely 400,000-450,000. Of the non-engineering graduate pool, we believe the available pool suitable for IT services jobs is limited. Hence, the company must ensure that proper training is awarded to these non-engineering graduates: (a) to make them billable; and (b) to stay away from any quality issues that could arise ahead. Further, this would ease the pressure on margins considering availability of a significantly larger pool at relatively lower costs in comparison with engineering graduates.

- **Strengthening training infrastructure – creating a competitive edge:** While attracting and retaining quality manpower would be a challenge going forward, Infosys believes that by strengthening the training infrastructure, the company will continue to have an upper edge. Currently Infosys has a total capacity to train around 25,000 employees annually, of which around 15,000 can be trained at its Mysore facility. This facility currently has 2,500 rooms for trainees and the plan is to increase this number to 10,000 going forward. This indicates that alongside recruitment of increasing number of freshers, Infosys is strengthening its training infrastructure to steer clear of possible quality/execution issues that could arise due to a greater fresher composition. To tap growing demand in Package Implementation, the company has a dedicated Package Implementation training center at Hyderabad with capacity to train 500-600 employees. Infosys believes that these centers afford Infosys a competitive edge.

- **Global recruitment – to increase the 'available' pool:** Another step in the direction of creating a substantial 'available' pool is a likely increase in international recruitment. Infosys has recently recruited 35 Chinese graduates from Universities in China and is toying with the idea of significantly increasing hiring in China going forward. Infosys has plans to recruit 10,000 employees in China alone over the next four years.

  Further, the company has set up a training center in China to train 100 employees in one single batch, currently served by a faculty of four, two of which are English-speaking Chinese. We note that besides India, global majors consider China as one of the preferred destinations for global outsourcing. In these circumstances, Infosys aims to be a competent offshore vendor from China in the next three years. Further plans include expansion of its employee teams mainly in markets such as the US, UK and Latin America.

Taking concrete steps to expand margins

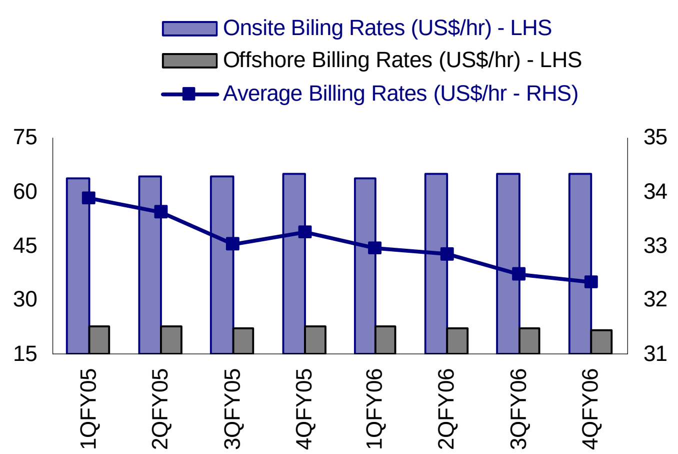
Infosys is also considering the following measures to maintain/improve its margins ahead:

- Change from monthly to hourly billing cycles, so that overtime hours become liable for charge etc.
- Sell non-AMD services outside the purview of the MSA (master services agreement), as these services can attract higher rates.
- Bid for big-ticket size orders on a fixed price basis to reduce margin pressures ahead. The company is also testing the concept of 'Shared Services' to improve efficiency — currently trial runs are ongoing with five key clients, wherein customers will be serviced from a common pool of employees.

Our expectation: We expect margins to remain stable over the next few years, but they could be lower in the short term due to the recent salary hikes.

Large-sized deals dilute impact of rising bill rates: In most cases, as existing contracts are renewed, Infosys is able to pass on a part of the cost increases to clients. However, this does not apply to fixed-price contracts. Also, large-sized contracts come at lower rates. Therefore, we do not expect any significant change in the billing rates, going forward.

AVERAGE BILLING RATES DECLINING

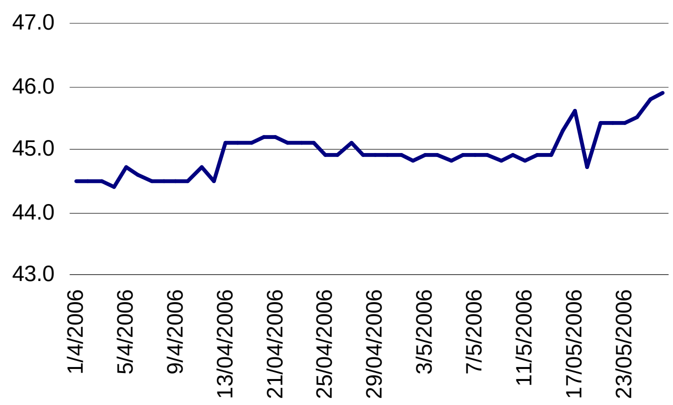


Source: Company/Motilal Oswal Securities

Although average onsite rates have improved marginally over the last eight quarters (1QFY05-4QFY06), offshore rates have declined marginally over the same period (see chart above). Change in billing rates is also a function of change in the services mix. Average billing rates have declined largely due to change in the revenue mix from onsite to offshore (offshore revenue contribution has increased from 48.1% in 1QFY05 to 50.7% in 4QFY06).

However, current rupee/dollar movement could provide positive surprises on EBITDA margins: The average rupee/dollar rate from April 2006 until date has depreciated by 0.32%. However, from the closing rate on 31 Mar 2006, the rupee has depreciated by 2.64% until now. Based on FY06 data and our calculations, for every one percentage rupee depreciation, Infosys' EBITDA margins will be positively impacted by 30bp-40bp. Hence, if the rupee continues to depreciate over the remainder of 1QFY07, margins for this quarter will be higher than expected. However, rupee depreciation will have an adverse impact on other income. Infosys has US$119m as outstanding in forward contracts and US$210m in options as end-March 2006.

RUPEE DEPRECIATING VIS-À-VIS US DOLLAR



Source: Company/Motilal Oswal Securities

Demand continues to be robust

- **Europe to outperform:** Management continues to remain bullish with respect to demand, going by the increasing trend of outsourcing as well as offshoring from the US as well as Europe. Within Europe, UK remains a high growth destination. France is also opening up in terms of outsourcing demand. However, Germany continues to remain conservative due to labor issues as well as language problems.

  Besides winning an outsourcing deal from ABN Amro, the company is witnessing good traction in terms of client inquiry from leading players in the Utility/ Engineering as well as Automobile companies based in Europe. We believe that traction will continue to outperform in Europe and will have a positive impact on the operating margins of the company considering the higher operating margins in Europe. We expect billing rates and operating margins in Europe to remain

REVENUE CONTRIBUTION BY GEOGRAPHY

	EBITDA MARGINS (%)				CONTRIBUTION TO REVENUES (%)				
	4QFY06	4QFY05	2HFY06	2HFY05	4QFY06	3QFY06	4QFY05	FY05	FY06
US	32.2	33.5	32.7	34.1	65.0	65.0	63.9	64.8	65.2
Europe	33.3	38.7	35.6	37.1	25.5	24.9	23.3	24.5	22.3
India	44.7	50.0	37.8	47.5	1.8	1.4	2.0	1.7	1.9
RoW	19.9	19.2	24.3	16.0	7.7	8.7	10.8	9.0	10.6

Source: Company/Motilal Oswal Securities

higher for a couple of years, as Europe is not a mature market yet in terms of outsourcing and offshoring.

- **Robust flow in RFPs:** The company is also witnessing a higher number of RFPs (seeking India-centric services) as compared to a year ago, indicating higher traction for offshore services. Infosys will not be bidding for such deals by undercutting rates, as this would mean compromising on its margins. Though management is on record that big deals will have lower margins initially, margins are expected to be in line with the company's average over the full contractual period based on the higher offshore component at a later stage.

- **BFSI — healthy demand continues - vertical likely to enter mature phase:** Though the company expects demand from the BFSI vertical to remain healthy due to inefficient systems, the vertical appears to have matured, mainly in the US. Several MNCs are considering opening captive centers in low cost destinations. For setting up such centers, customers are seeking the support of leading Indian IT vendors to set up these centers in India, although the vendor will continue to play a leading role with its customer. We believe that this would have a negative impact going forward largely for growth in ITES services. We therefore believe that margins in BFSI are not likely to improve going forward.

- Apart from BFSI and Telecom, the company expects healthy growth from Utilities, Energy, Retail and Healthcare segments. While traditional IT services should continue to do well, the company expects high growth in new services including Testing, Infrastructure management services, BPO and consultancy services, going forward.

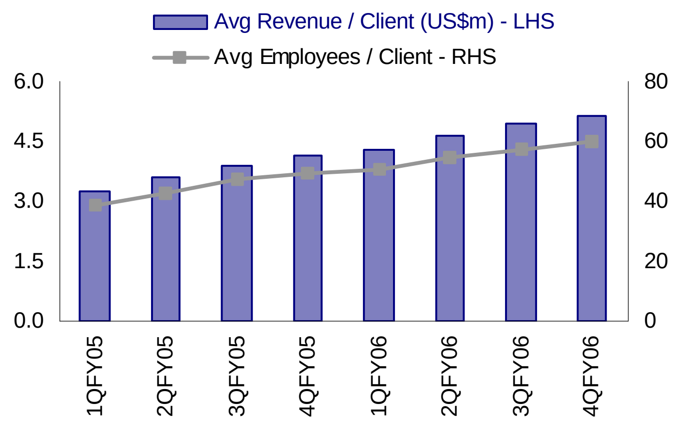
- **Robust demand leads to increased client mining:** Robust demand growth has led to healthy client mining by Infosys over the past eight quarters. Average revenues per client have improved at a CQGR of 6.9% during the past 8 quarters and average employees deployed per client have also improved by 6.5% during the same period. This indicates that volumes largely drive much of the growth within each client, indicating growing demand. If we correlate the increase in per client revenues with client concentration, we believe that higher mining with each client would be a result of growth across clients instead of being concentrated within a clutch of clients.

REVENUE CONTRIBUTION BY VERTICAL

	EBITDA MARGINS (%)				CONTRIBUTION TO REVENUES (%)				
	4QFY06	4QFY05	2HFY06	2HFY05	4QFY06	3QFY06	4QFY05	FY05	FY06
BFSI	29.6	32.0	31.3	32.6	36.0	36.0	33.8	36.0	34.6
Manufacturing	30.4	33.2	30.9	32.5	14.5	14.1	14.0	13.9	14.4
Telecom	38.6	36.6	38.9	35.8	10.2	10.3	9.1	10.1	9.8
Retail	32.6	32.6	32.7	33.8	16.3	15.8	19.4	16.5	18.5
Others	30.7	33.7	32.4	32.4	23.0	23.8	23.7	23.5	22.7

Source: Company/Motilal Oswal Securities

AVERAGE REVENUE/ CLIENT IS RISING (US$ M)



Source: Company/Motilal Oswal Securities

TOP CLIENTS NOW CONTRIBUTE A LOWER PROPORTION OF REVENUES

	1QFY05	4QFY06
Revenues from Top Client (%)	5.3	4.7
Revenues from Top5 Clients (%)	21.6	18.6
Revenues from Top 10 Clients (%)	34.3	31
CQGR in Revenues (from 1QFY05-4QFY06)		8.1
CQGR in Average Revenue /Client (%)		6.9
CQGR in Average Employees/ Client (%)		6.5

Source: Company/Motilal Oswal Securities

Considering Infosys' strong client mining capability and the growing demand for outsourcing and offshoring (both from the US and Europe), with consistent client addition of 30+ every quarter, we believe that Infosys is poised for strong growth in the future.

Valuation and recommendation

Maintain Buy - upside of 23%: We expect Infosys to report strong growth of 30.6% CAGR over FY06-08. However, in the near term, margins are likely to be subdued due to salary hikes as well as higher visa costs. While demand continues to be robust (considering Infosys' measures to fight supply-side concerns as well as maintain/ improve margins), we expect margins to move in narrow band going forward, resulting in relatively higher earnings visibility ahead.

In the past one month, the stock has corrected by almost 14.3% and we believe that the current price is not fully factoring the abovementioned margin positives. The current price decline should be used as a buying opportunity. At CMP of Rs3,028, the stock trades at 25.2x FY07E and 20.3x FY08E. We maintain **Buy** with a target price of Rs3,730 – upside of 23.2%.

INCOME STATEMENT (RS MILLION)

Y/E MARCH	2004	2005	2006	2007E	2008E
Sales	**47,609**	**71,296**	**95,216**	**127,775**	**162,409**
Change (%)	*31.4*	*49.8*	*33.5*	*34.2*	*27.1*
Software Develop. Exp.	24,953	37,647	50,654	68,557	88,022
Selling and Mktg. Exp.	3,351	4,610	6,005	7,950	10,069
Administration Exp.	3,469	5,690	7,639	9,947	12,538
EBITDA	**15,837**	**23,350**	**30,918**	**41,321**	**51,780**
% of Net Sales	*33.3*	*32.8*	*32.5*	*32.3*	*31.9*
Depreciation	2,309	2,869	4,371	5,750	7,308
Other Income	1,274	1,239	1,396	1,896	2,280
PBT	**14,801**	**21,720**	**27,943**	**37,467**	**46,751**
Tax	2,270	3,256	3,132	4,309	5,610
Rate (%)	*15.3*	*15.0*	*11.2*	*11.5*	*12.0*
Extraordinary		452	-18		
PAT	**12,531**	**18,916**	**24,793**	**33,158**	**41,141**
Minority Interest			210	85	0
Net Income	**12,531**	**18,916**	**24,583**	**33,073**	**41,141**
Change (%)	*30.8*	*51.0*	*30.0*	*34.5*	*24.4*

BALANCE SHEET (RS MILLION)

Y/E MARCH	2004	2005	2006	2007E	2008E
Share Capital	333	1,353	1,380	1,380	1,380
Share Premium	4,609	8,999	15,430	15,430	15,430
Reserves	27,554	41,900	52,850	78,769	110,998
Net Worth	**32,496**	**52,251**	**69,660**	**95,579**	**127,808**
Preference Capital	936	935	0	0	0
Minority Interest	0	0	680	0	0
Loans	0	0	0	0	0
Capital Employed	**33,431**	**53,188**	**70,340**	**95,579**	**127,808**
Gross Block	16,337	22,873	29,830	50,930	63,930
Less : Depreciation	8,098	10,308	13,280	19,030	26,338
Net Block	**8,238**	**12,565**	**16,550**	**31,900**	**37,592**
CWIP	2,081	3,177	5,710	5,000	3,000
Investments	9,455	12,108	7,550	8,000	8,500
Curr. Assets	**31,340**	**39,664**	**63,990**	**73,161**	**111,380**
Debtors	6,515	13,220	16,080	22,428	26,517
Cash & Bank Balance	17,215	15,756	34,290	31,689	62,487
Loans & Advances	7,211	10,244	12,970	18,207	21,421
Other Current Assets	400	444	650	837	954
Current Liab. & Prov	**17,682**	**14,326**	**23,460**	**22,482**	**32,662**
Creditors	4,499	5,354	7,320	9,483	11,875
Other liabilites	1,310	1,207	2,020	1,913	3,059
Provisions	11,872	7,766	14,120	11,085	17,728
Net Current Assets	**13,658**	**25,338**	**40,530**	**50,679**	**78,718**
Application of Funds	**33,431**	**53,187**	**70,340**	**95,579**	**127,809**

E: MOSt Estimates

RATIOS

Y/E MARCH	2004	2005	2006	2007E	2008E
Basic (Rs)					
EPS	**47.0**	**69.0**	**89.3**	**120.0**	**149.3**
Cash EPS	55.9	81.4	105.1	140.9	175.8
Book Value	121.9	195.2	252.8	346.9	463.8
DPS	32.4	12.9	44.9	22.8	28.4
Payout % (Incl.Div.Taxes)	77.3	20.6	57.4	21.7	21.7
Valuation (x)					
P/E		43.9	33.9	25.2	20.3
Cash P/E		37.2	28.8	21.5	17.2
EV/EBITDA		34.1	25.3	19.0	14.5
EV/Sales		11.2	8.2	6.1	4.6
Price/Book Value		15.5	12.0	8.7	6.5
Dividend Yield (%)		0.4	1.5	0.8	0.9
Profitability Ratios (%)					
RoE	41.0	44.6	40.3	40.0	36.8
RoCE	47.7	50.2	45.2	45.2	41.9
Turnover Ratios					
Debtors (Days)	50	68	62	64	60
Fixed Asset Turnover (x)	2.9	3.1	3.2	2.5	2.5
Leverage Ratio (x)					
Debt/Equity Ratio(x)	0.0	0.0	0.0	0.0	0.0

CASH FLOW STATEMENT (RS MILLION)

Y/E MARCH	2004	2005	2006	2007E	2008E
CF from Operations	14,840	21,333	29,182	38,908	48,449
Cash for Working Capital	-10,773	13,095	-3,549	12,563	-2,877
Net Operating CF	**25614**	**8238**	**32731**	**26345**	**51326**
Net Purchase of FA	-4,918	-7,633	-9,490	-20,390	-11,000
Net Purchase of Invest.	-7,113	-3,574	4,558	-450	-500
Net Cash from Invest.	**-12031**	**-11207**	**-4932**	**-20840**	**-11500**
Proceeds from Pvt. Place.	0	5,409	6,458	0	0
Proceeds from LTB/STB	0	0	0	0	0
Dividend Payments	-9,730	-3,900	-15,723	-8,106	-9,028
Cash Flow from Fin.	**-9730**	**1509**	**-9265**	**-8106**	**-9028**
Free Cash Flow	7,478	20,695	605	23,241	5,955
Net Cash Flow	**3853**	**-1459**	**18534**	**-2601**	**30798**
Opening Cash Balance	**13,362**	**17,215**	**15,756**	**34,290**	**31,689**
Add: Net Cash	3,853	-1,459	18,534	-2,601	30,798
Closing Cash Balance	**17,215**	**15,756**	**34,290**	**31,689**	**62,487**

NOTES

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Disclosure of Interest Statement	Infosys Technologies
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No

MOSt is not engaged in providing investment-banking services.