

## Company

13 July 2010 | 10 pages

# Infosys Technologies (INFY.BO)

Equity

## 1QFY11 Results: Good Volumes; Pricing/Margins Disappoint

- Good volume growth but pricing/margins disappoint** — Infosys reported 1Q revenues of US\$1,358m (+4.8% QoQ, our exp: US\$1,369m), EBIT margin decline of ~200bps and net profits of Rs14.9b (-8% QoQ, our exp: Rs16.1b). Volume growth was strong at ~7.6% QoQ while pricing declined ~60bps. For FY11, Infosys raised the revenue growth guidance (\$-terms) to 19%-21% growth (from 16%-18% earlier) and EPS guidance to Rs112-117 (from Rs107-111 earlier).
- The positives** — (a) Volume growth for IT Services at ~7.6% was strong; (b) Revenue guidance of 4%-5% QoQ growth for 2Q is good. FY revenue guidance has also been raised to 19%-21% growth, which was better than most expectations; (c) Gross headcount addition guidance raised to 36k (vs. 30k earlier) – however part of it would be offset by higher attrition.
- The negatives** — (a) Offshore pricing decline surprised; (b) BPO revenue decline was a negative surprise – margins also declined sharply; (c) Margins disappointed given that investors are used to some very good cost management from Infosys; (d) Europe continues to be sluggish; (e) Supply side worries increased – attrition sees a meaningful uptick to 15.8% (TTM).
- Implications for the sector** — (a) Supply side issues increasing – Infosys, despite being proactive with wage hikes, has seen a uptick in attrition – margin management could be a challenge; (b) Europe outlook continues to be challenging; (c) Pricing uptick could take more time than anticipated.
- Upgrades, if at all, unlikely until 2Q results; Maintain Hold** — The consensus EPS estimate (FY11E) is ~Rs122 (vs. revised company guidance of Rs112-117), and the Street was expecting the upgrade cycle to continue. A large part of the management EPS guidance upgrade was due to currency (now assumes Rs46.45/\$ vs. Rs44.5/\$ earlier). We believe EPS upgrades (barring currency related), if any, are unlikely to be seen until the September quarter results, and with valuations of ~23x FY11E we see upside as limited, thus maintain our Hold.

<b>Hold/Low Risk</b>	<b>2L</b>
Price (13 Jul 10)	Rs2,810.95
Target price	Rs2,935.00
Expected share price return	4.4%
Expected dividend yield	1.1%
<b>Expected total return</b>	<b>5.5%</b>
Market Cap	Rs1,612,994M
	US\$34,551M

### Price Performance (RIC: INFY.BO, BB: INFO IN)



### Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2009A	59,880	104.42	28.5	26.9	8.8	37.4	0.8
2010A	62,660	109.31	4.7	25.7	7.0	30.3	0.9
2011E	70,290	123.04	12.6	22.8	5.7	27.4	1.1
2012E	82,027	143.58	16.7	19.6	4.7	26.1	1.3
2013E	95,556	167.26	16.5	16.8	3.9	25.1	1.5

Source: Powered by dataCentral

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## Key Highlights of 1QFY11

- Revenues were US\$1.36b, up ~5% QoQ (CIRA expectations: US\$1.37b).
- EBITDA margin of 31.6% (CIRA expectations: 32.7%), a decline of ~240bps sequentially. This was primarily on account of wage hikes and pricing pressure partly offset by higher utilization.
- Wage hikes impacted margins negatively by ~300bps and offset by ~200bps due to higher utilization sequentially.
- Net profit of Rs14.9b (CIRA expectations: Rs16.1b) was below expectation.
- Constant currency realizations declined ~60bps QoQ on a blended basis. Offshore realizations declined ~300bps QoQ. Management attributed this to the tail-effect of what happened last year in terms of pricing discussions/negotiations. Onsite pricing was strong at ~2.2% increase QoQ.
- IT volumes increased ~7.6% sequentially on a blended basis – offshore volumes increased ~8% qoq.
- Headcount increased by 1,026 employees on a net basis. Headcount growth was muted but management has raised full year hiring guidance – now expecting to add ~36,000 employees in the year (against 30,000 earlier) – however, part of this will be offset by higher attrition given that it is gross hiring guidance. For Q2, management has guided to hiring of ~14,000 employees.
- Growth was led by Financial Services, Energy and Utilities, and Retail where revenues increased ~9%, ~8% and ~6% QoQ respectively. Telecom (-3% QoQ) and Manufacturing (+1% QoQ) were sluggish.
- In terms of service lines, growth was led by product engineering, testing and application maintenance. Consulting/package implementation and infrastructure services were sluggish.
- BPO had a disappointing quarter with revenues declining sequentially. Net margins for BPO contracted sharply to ~8% (from ~16% in 4QFY10).
- Top 10 clients grew ~6% QoQ.
- Attrition increased sharply by ~240bps to 15.8% on TTM (trailing twelve month) basis.
- FY11 guidance now implies ~19%-21% revenue growth (\$-terms) and Rs112-117 on EPS (upgrade largely on account of currency assumptions, in our view). Margin decline implied in the guidance is ~150bps YoY, which has been maintained.

## Result Tables

Figure 1. Key Financials

RsM	1Q10	4Q10	1Q11	QoQ	YoY
<b>Revenue (US\$M)</b>	<b>1,122</b>	<b>1,296</b>	<b>1,358</b>	<b>4.8%</b>	<b>21.0%</b>
<b>Revenue</b>	<b>54,720</b>	<b>59,440</b>	<b>61,980</b>	<b>4.3%</b>	<b>13.3%</b>
Cost of revenue	29,150	31,840	34,430	8.1%	18.1%
Gross profit	25,570	27,600	27,550	-0.2%	7.7%
Gross margin	46.7%	46.4%	44.4%	-198bp	-228bp
Operating expenses	6,890	7,380	7,950	7.7%	15.4%
<b>EBITDA</b>	<b>18,680</b>	<b>20,220</b>	<b>19,600</b>	<b>-3.1%</b>	<b>4.9%</b>
<b>EBITDA margin</b>	<b>34.1%</b>	<b>34.0%</b>	<b>31.6%</b>	<b>-239bp</b>	<b>-251bp</b>
Depreciation & amortization	2,220	2,200	2,050	-6.8%	-7.7%
<b>EBIT</b>	<b>16,460</b>	<b>18,020</b>	<b>17,550</b>	<b>-2.6%</b>	<b>6.6%</b>
<b>EBIT margin</b>	<b>30.1%</b>	<b>30.3%</b>	<b>28.3%</b>	<b>-200bp</b>	<b>-176bp</b>
Other income	2,690	2,560	2,390	-6.6%	-11.2%
Profit before tax	19,150	20,580	19,940	-3.1%	4.1%
Income tax expense	3,880	4,410	5,060	14.7%	30.4%
Income from operations	15,270	16,170	14,880	-8.0%	-2.6%
Affiliates/Minority	0	0	0	NA	NA
Net income - recurring	15,270	16,170	14,880	-8.0%	-2.6%
EO income/(loss)	0	0	0	NA	NA
Net profit	15,270	16,170	14,880	-8.0%	-2.6%
EPS - basic	26.65	28.33	26.06	-8.0%	-2.2%
EPS - fully diluted	26.62	28.30	26.04	-8.0%	-2.2%

Source: Company Reports

Figure 2. FY11 Guidance

	Guidance		Guidance post Q1		Guidance revision	
	Lower	Upper	Lower	Upper	Lower	Upper
Revenue (RsM)	247,960	252,390	264,410	268,850	6.6%	6.5%
Revenue (US\$M)	5,570	5,670	5,720	5,810	2.7%	2.5%
EPS - basic (Rs)	106.82	111.28	112.21	116.73	5.0%	4.9%
INR/\$ assumption		44.50		46.45		4.4%

Source: Company Reports

Figure 3. Q2 Guidance

	Guidance		Implied Growth	
	Lower	Upper	Lower	Upper
Revenue (RsM)	65,630	66,260	5.9%	6.9%
Revenue (US\$M)	1,413	1,427	4.1%	5.1%
EPS - basic (Rs)	27.42	27.95	5.2%	7.3%

Source: Company Reports

**Figure 4. Key Client Metrics**

	1Q10	2Q10	3Q10	4Q10	1Q11
Active Clients	569	571	568	575	590
Added during the period	27	35	32	47	38
\$1m+ clients	330	330	336	338	341
\$5m+ clients	151	150	152	159	170
\$10m+ clients	104	96	93	97	103
\$20m+ clients	61	59	60	59	60
\$30m+ clients	45	41	41	41	43
\$50m+ clients	19	21	22	26	26
\$70m+ clients	12	11	12	12	13
\$100m+ clients	4	5	6	6	8
\$200m+ clients	1	1	2	1	1
Clients > 5% of revenue	0	0	0	0	0
Revenue - top client	4.5%	4.6%	4.7%	4.6%	4.9%
Revenue - top 5 client	16.3%	16.5%	17.6%	15.8%	15.4%
Revenue - top 10 client	25.8%	26.2%	27.5%	25.8%	26.1%
Repeat Business	98.7%	98.0%	97.0%	95.4%	99.4%
DSO - TTM (in days)	56	56	57	59	60

Source: Company Reports

**Figure 5. Revenue Mix**

	1Q10	2Q10	3Q10	4Q10	1Q11
<b>Geographic wise</b>					
North America	64.7%	65.9%	66.6%	66.1%	67.3%
Europe	24.7%	23.2%	21.9%	22.5%	20.0%
India	0.9%	1.2%	1.2%	1.4%	1.7%
RoW	9.7%	9.7%	10.3%	10.0%	10.7%
<b>Service line wise</b>					
Application development	19.3%	18.1%	17.8%	16.8%	16.9%
Application maintenance	23.2%	22.7%	24.5%	22.8%	23.9%
BPO	6.1%	6.2%	5.9%	6.2%	5.7%
Consulting & PI	24.4%	23.8%	23.3%	26.0%	24.9%
Infrastructure Management	6.6%	7.8%	7.1%	7.2%	6.9%
Product Engg Services	2.4%	2.3%	2.4%	1.8%	2.1%
System Integration	3.8%	4.4%	4.1%	4.5%	4.2%
Testing Services	6.2%	6.2%	6.5%	6.6%	7.3%
Others	4.0%	4.4%	4.5%	3.1%	3.4%
Products	4.0%	4.1%	3.9%	5.0%	4.7%
<b>Vertical wise</b>					
Insurance	7.1%	7.4%	8.5%	7.7%	8.4%
Banking & FS	25.9%	26.1%	26.1%	27.1%	27.7%
Manufacturing	20.5%	19.3%	19.3%	20.2%	19.5%
Retail	13.2%	14.1%	13.1%	13.0%	13.2%
Telecom	16.9%	16.2%	16.2%	15.3%	14.1%
Energy & Utilities	5.7%	5.9%	6.1%	5.8%	6.0%
Transportation & Logistics	2.3%	2.3%	1.8%	1.8%	1.8%
Services	4.9%	5.0%	5.1%	4.9%	4.8%
Others	3.5%	3.7%	3.8%	4.2%	4.5%

Source: Company Reports

Figure 6. Key HR Metrics

	1Q10	2Q10	3Q10	4Q10	1Q11
IT and BPO professionals	96,334	97,594	103,476	106,864	108,495
- Billable	88,061	87,798	89,086	93,254	95,863
- Banking Business Unit	2,664	2,800	4,345	4,730	5,029
- Trainees	5,609	6,996	10,045	8,880	7,603
Sales & support	7,571	7,859	6,406	6,932	6,327
<b>Total employees</b>	<b>103,905</b>	<b>105,453</b>	<b>109,882</b>	<b>113,796</b>	<b>114,822</b>
Gross addition	3,538	6,069	8,719	9,313	8,859
Net addition	-945	1,548	4,429	3,914	1,026
Attrition% (TTM) - standalone	11.1%	10.9%	11.6%	13.4%	15.8%
<b>Utilization</b>					
- including trainees	67.0%	67.3%	68.8%	69.3%	73.0%
- excluding trainees	70.9%	73.2%	76.2%	77.1%	78.7%

Source: Company Reports

Figure 7. Key Execution Metrics

	1Q10	2Q10	3Q10	4Q10	1Q11
<b>Infosys consolidated</b>					
Billed effort (person-mths)	195,725	198,511	208,980	218,687	233,756
- Onsite	44,458	44,804	46,925	49,347	53,519
- Offshore	151,267	153,707	162,055	169,340	180,237
Billed effort distribution (%)					
- Onsite	22.7%	22.6%	22.5%	22.6%	22.9%
- Offshore	77.3%	77.4%	77.5%	77.4%	77.1%
Revenue distribution (%)					
- Onsite	46.4%	46.0%	46.1%	46.0%	48.0%
- Offshore	53.6%	54.0%	53.9%	54.0%	52.0%
<b>IT Services</b>					
Billed effort distribution (person-mths)	149,961	153,388	162,755	171,232	184,279
- Onsite	44,231	44,435	46,686	49,183	52,630
- Offshore	105,730	108,953	116,069	122,049	131,649
Billed effort distribution (%)					
- Onsite	29.5%	29.0%	28.7%	28.7%	28.6%
- Offshore	70.5%	71.0%	71.3%	71.3%	71.4%
Revenue distribution (%)					
- Onsite	51.4%	50.9%	50.9%	51.5%	52.6%
- Offshore	48.6%	49.1%	49.1%	48.5%	47.4%

Source: Company Reports

## Infosys Technologies

### Company description

Infosys is the second-largest Indian IT services company with more than 110,000 professionals, and is a leader in the offshore services space. Infosys provides business consulting, application development & maintenance and engineering services to ~570 active clients across verticals such as Banking, Financial Services, Insurance, Retail, Manufacturing and Utilities in the Americas, Europe and Asia Pacific. Infosys also sells a core banking application, Finacle, which is used by leading banks in India, the Middle East, Africa and Europe. Its subsidiary, Infosys BPO, which employs about 18,000 people, is a provider of BPO services.

### Investment strategy

We rate Infosys shares as Hold/Low Risk (2L) for valuation reasons. We are positive on the company's fundamentals. Offshore IT outsourcing has become a mainstream option, and we think that scale and scalability, along with an ability to move up the value chain, are key criteria for successful offshore vendors. In this respect, Infosys appears well positioned and continues to gain ground given its strong branding and industry-leading sales force. We expect Infosys to deliver a revenue CAGR of ~21% (US\$ terms) and an earnings CAGR of ~15% for FY10-13E. Unlike other high-growth firms in other industries, Infosys continues to generate solid FCF and its RoE of ~30% remains well above its cost of capital.

### Valuation

Our Rs2,935 target price for Infosys is based on 22x the average of FY11-12E EPS. This is around the mid-point of the last 3-year trading band of 11x-30x 12-month forward earnings and factors in some deceleration in growth. Our estimates continue to assume a certain P/E premium to the market; this is justified, in our view, given the strong FCF and ROIC for Infosys vs. the overall market. We believe P/E remains the most appropriate valuation measure given Infosys' profitability record and higher earnings visibility.

### Risks

We rate Infosys Low Risk given its superior branding, management quality and cost optimization abilities. This is in line with our quantitative risk-rating system, which tracks 260-day historical share price volatility. Key downside risks to our target price include: 1) any significant appreciation of the rupee against the USD/EUR/GBP; 2) pressure on billing rates (as Infosys still continues to enjoy a 10-15% premium in its billing rates); 3) a prolonged slowdown in the US economy; and 4) limited H1B visas. Key upside risks include: 1) any significant depreciation of the rupee against the USD/EUR/GBP; and 2) a pickup in the US/global economy.

# Appendix A-1

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#### Fundamental Research

Analyst: Surendra Goyal, CFA

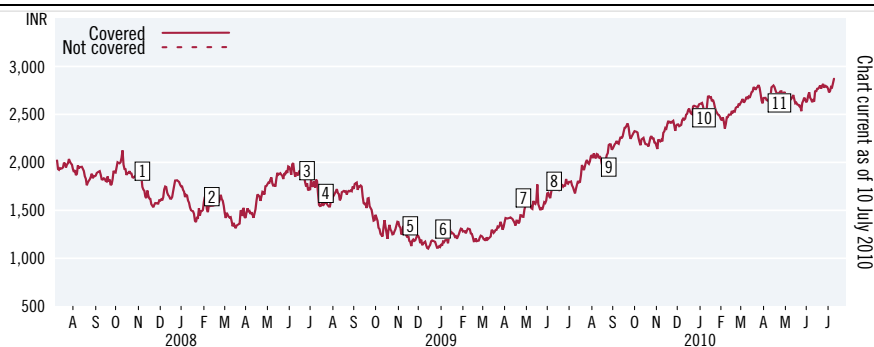


Chart current as of 10 July 2010

	Date	Rating	Target Price	Closing Price
1	7-Nov-07	1L	*2,190.00	1,743.85
2	13-Feb-08	*1M	*2,060.00	1,549.15
3	26-Jun-08	1M	*2,175.00	1,781.85
4	23-Jul-08	1M	*1,910.00	1,603.70

	Date	Rating	Target Price	Closing Price
5	19-Nov-08	1M	*1,420.00	1,172.00
6	4-Jan-09	1M	*1,350.00	1,130.95
7	28-Apr-09	*1L	*1,650.00	1,431.55
8	10-Jun-09	1L	*2,060.00	1,803.25

	Date	Rating	Target Price	Closing Price
9	26-Aug-09	*2L	*2,290.00	2,181.35
10	7-Jan-10	2L	*2,785.00	2,525.25
11	23-Apr-10	2L	*2,935.00	2,728.10

\* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Data current as of 30 Jun 2010

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