

## Company Flash

13 April 2007 | 11 pages

# Infosys Technologies (INFY.BO)

## Buy: Disappointing Quarter; Strong Outlook

- Quarter below expectation; guidance in line** — 4QFY07 results were below our expectations with 5% revenue growth (US\$ terms) qoq. Higher non-operating items like higher other income and tax reversals resulted in a significantly higher net profit of Rs11.44b. However, more importantly, guidance was strong at ~28-30% top line growth (US\$ terms) and EPS growth of ~20-22%.
- What does guidance imply** — Q1 guidance remains muted at 4.7-5.2% (US\$ terms) revenue growth and EPS decline of 1.5%. However, it implies strong growth of ~6-7% & ~8-9% qoq respectively from Q2-Q4.
- Strong statement on demand; top client grows 30% qoq** — We believe that the 28-30% revenue growth guidance (US\$ terms) is testimony of strong demand. Management talked of low single-digit growth in IT budgets and increasing momentum for offshoring. Its top client grew 30% qoq and the top five grew 18.5% qoq – belying concerns about top clients like BT and ABN Amro – and it won multi-million dollar orders from ABN AMRO in 4Q07.
- Another quarter of solid pricing** — For FY07, onsite pricing was up 4.4% while offshore pricing was up 2.7% (Q4 saw an increase of 1.8% in onsite and 1.4% offshore). This is line with what sector peers have been indicating.
- Infosys remains our top Buy** — Infosys completed a very good FY07 and guided to a strong FY08. Strong statement on demand should address investor concerns, which have surfaced recently. The stock trades at 24.7x FY08E earnings and remains our top pick along with TCS (TCS.BO - Rs1,239; 1L).

<b>Buy/Low Risk</b>	<b>1L</b>
Price (13 Apr 07)	Rs2,095.00
Target price	Rs2,660.00
Expected share price return	27.0%
Expected dividend yield	0.7%
<b>Expected total return</b>	<b>27.7%</b>
Market Cap	Rs1,168,693M US\$27,383M

### Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2005A	18,917	34.36	48.5	61.0	21.7	44.6	0.4
2006A	24,599	43.82	27.5	47.8	16.5	40.4	1.1
2007E	37,277	65.58	49.7	31.9	11.3	43.1	0.6
2008E	48,287	84.68	29.1	24.7	8.1	39.1	0.7
2009E	59,867	104.99	24.0	20.0	6.0	35.6	0.9

Source: Powered by dataCentral

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### Is Q1 guidance very muted?

Q1 guidance factors in the impact of wage hikes, visa costs and full impact of ESOP related dilution and hence is muted at the EPS line.

- Q4FY07 had Rs1.19b of other income and tax reversals (Rs1.25b). If one adjusts the tax reversal, then net income in the quarter would have been Rs10.19b, meaning recurring EPS of Rs.18.1. Wage hike of 5-6% onsite and 13-15% offshore and visa costs resulted in management guiding to a EPS decline of 1.5% qoq for Q1FY08 (if one were to exclude the tax reversals).
- Also note that this incorporates some ESOP-related dilution in Q1, as Q4 would be a weighted average number of shares taken (which would not have taken into account full dilution). Our estimates suggest that this impact would be 1.5%. Essentially, management implies flattish recurring net profit in Q1FY08 over Q4FY07.

### What does FY08 guidance imply – key points

- First, EPS guidance was diluted by 3% due to ESOP-related dilution. So the net profit growth assumption implied in the guidance is 3% higher than the EPS guidance indicated.
- Assuming that Infosys meets the higher end of the guidance in Q1, the guidance implies 5.7-6.8% qoq growth in top line (US\$ terms) over next few quarters – highlighting the confidence on demand.
- Assuming that Infosys meets its first quarter EPS guidance of Rs17.84 per share, FY08 guidance implies 7.9-9% qoq growth in EPS over Q2-Q4FY08.

### Margin assumptions for next year in guidance

- Negative impact – Management has indicated that there will be negative impact of ~300bp due to wages and ~150bp due to rupee.
- Counterbalanced by – The negative impact will be counterbalanced by utilization, SG&A leverage and productivity gains.
- Net margin is likely to go up due to the upward movement of interest rates in the economy.
- Net-net, guiding for another year of flat margins – Infosys remains the best at cost optimization.

### Remain buyers

Infosys continues to deliver strongly on revenue as well as cost optimization measures. We forecast an industry leading 34% CAGR in topline and EPS over FY06-FY09E. The stock trades at 24.7x FY08E – remains out top pick in the IT services space (along with TCS).

Figure 1. Infosys – Key Financial

	4Q06	3Q07	4Q07	QoQ	YoY
Revenue (US\$ m)	524	821	863	5.1%	64.7%
Revenue	26,240	36,550	37,720	3.2%	43.8%
Cost of revenue	14,220	19,380	20,210	4.3%	42.1%
Gross profit	12,020	17,170	17,510	2.0%	45.7%
Gross margin	45.8%	47.0%	46.4%	-56bp	61bp
Operating expenses	3,690	5,210	5,540	6.3%	50.1%
EBITDA	8,330	11,960	11,970	0.1%	43.7%
EBITDA margin	31.7%	32.7%	31.7%	-99bp	-1bp
Depreciation and amortization	1,440	1,410	1,450	2.8%	0.7%
EBIT	6,890	10,550	10,520	-0.3%	52.7%
EBIT margin	26.3%	28.9%	27.9%	-97bp	163bp
Other income	440	590	1,190	101.7%	170.5%
Profit before tax	7,610	11,140	11,720	5.2%	54.0%
Income tax expense	810	1,300	270	-79.2%	-66.7%
Income from operations	6,800	9,840	11,450	16.4%	68.4%
Affiliates/Minority	-70	-10	-10	0.0%	-85.7%
Net income - recurring	6,730	9,830	11,440	16.4%	70.0%
EO income/(loss)	0	0	0	n.a.	n.a.
Net profit	6,730	9,830	11,440	16.4%	70.0%
EPS - basic	12.23	17.65	20.33	15.2%	66.2%
EPS - fully diluted	11.92	17.25	19.97	15.8%	67.6%

Source: Company Reports

Figure 2. Infosys – Annual Guidance

Infosys FY08 guidance	Guidance		Implied growth	
	Lower	Upper	Lower	Upper
Revenue (Rs m)	170,380	173,080	22.6%	24.6%
Revenue (\$ m)	3,950	4,020	27.8%	30.1%
EPS (Rs)	80.29	81.58	16.1%	18.0%
INR/USD assumption		43.10		

Source: Company Reports

Figure 3. Infosys – Quarterly guidance

Infosys 1Q08 guidance	Guidance		Implied growth	
	Lower	Upper	Lower	Upper
Revenue (Rs m)	38,960	39,130	3.3%	3.7%
Revenue (\$ m)	904	908	4.8%	5.2%
EPS (Rs)	17.84	17.84	-12.2%	-12.2%

Source: Company Reports

Figure 4. Infosys – Key HR metrics

	1Q07	2Q07	3Q07	4Q07
IT and BPO professionals	54,606	61,966	65,293	68,156
- Billable	48,438	53,873	58,073	61,917
- Banking Business Unit	1,817	1,809	1,967	2,053
- Trainees	4,351	6,284	5,253	4,186
Sales & support	3,803	4,184	4,039	4,085
Total employees	58,409	66,150	69,332	72,241
Gross addition	8,097	10,795	6,062	5,990
Net addition	5,694	7,741	3,282	2,809
Attrition % (TTM) - Infosys stand alone	11.9%	12.9%	13.5%	13.7%
<b>Utilization</b>				
- including trainees	71.1%	67.5%	67.5%	67.9%
- excluding trainees	76.1%	77.5%	75.8%	73.0%

Source: Company Reports

Figure 5. Infosys – Key Execution metrics

	1Q07	2Q07	3Q07	4Q07
<b>Infosys consolidated</b>				
Billed effort (person-months)	109,818	121,845	133,711	138,852
- Onsite	30,051	33,346	35,368	36,752
- Offshore	79,767	88,499	98,343	102,100
<b>Billed effort distribution (%)</b>				
- Onsite	27.4%	27.4%	26.5%	26.5%
- Offshore	72.6%	72.6%	73.5%	73.5%
<b>Revenue distribution (%)</b>				
- Onsite	50.5%	50.3%	49.2%	49.8%
- Offshore	49.5%	49.7%	50.8%	50.2%
<b>IT Services</b>				
Billed effort distribution (person-months)	90,198	100,292	107,679	111,587
- Onsite	29,861	33,146	35,175	36,584
- Offshore	60,337	67,146	72,504	75,003
<b>Billed effort distribution (%)</b>				
- Onsite	33.1%	33.0%	32.7%	32.8%
- Offshore	66.9%	67.0%	67.3%	67.2%
<b>Revenue distribution (%)</b>				
- Onsite	54.4%	54.4%	54.0%	54.3%
- Offshore	45.6%	45.6%	46.0%	45.7%

Source: Company Reports

Figure 6. Infosys – Revenue Distribution

	1Q07	2Q07	3Q07	4Q07
<b>Geographic wise</b>				
North America	64.0%	63.7%	63.2%	62.6%
Europe	26.2%	25.8%	26.8%	26.6%
India	1.4%	1.6%	1.8%	1.5%
RoW	8.4%	8.9%	8.2%	9.3%
<b>Service line wise</b>				
Development	21.3%	21.4%	20.1%	21.3%
Maintenance	29.9%	29.2%	29.8%	28.4%
Re-engineering	2.6%	2.3%	2.1%	1.5%
Package implementation	16.5%	17.0%	17.9%	18.4%
Consulting	3.0%	3.6%	3.3%	4.3%
Testing	6.2%	6.8%	7.0%	7.3%
Engineering services	1.8%	1.6%	1.5%	1.6%
Business process management	4.2%	4.5%	4.9%	5.2%
Other services	10.8%	9.9%	9.1%	8.2%
Products	3.7%	3.7%	4.3%	3.8%
<b>Vertical wise</b>				
Insurance	7.0%	6.7%	7.6%	7.4%
Banking & FS	29.4%	30.7%	31.0%	29.6%
Manufacturing	14.5%	14.0%	12.8%	12.9%
Retail	9.7%	9.0%	10.5%	10.8%
Telecom	17.7%	18.9%	18.3%	21.9%
Energy & Utilities	5.4%	5.6%	5.4%	4.8%
Transportation & Logistics	3.3%	2.7%	2.0%	1.8%
Services	8.7%	7.7%	8.3%	7.9%
Others	4.3%	4.7%	4.1%	2.9%

Source: Company Reports

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Figure 7. Infosys – Key Client metrics

	1Q07	2Q07	3Q07	4Q07
Active Clients	469	476	488	500
Added during the quarter	38	45	43	34
No. of million dollar clients	221	232	256	275
No. of 5mn+ dollar clients	94	97	108	107
No. of 10mn+ dollar clients	56	61	67	71
No. of 20mn+ dollar clients	28	29	35	36
No. of 30mn+ dollar clients	19	20	22	25
No. of 40mn+ dollar clients	15	16	17	16
No. of 50mn+ dollar clients	11	12	11	12
No. of 70mn+ dollar clients	3	6	8	9
No. of 90mn+ dollar clients	2	3	2	4
Revenue - top client	5.8%	6.6%	6.9%	8.5%
Revenue - top 5 client	19.5%	21.0%	18.9%	21.3%
Revenue - top 10 client	31.7%	32.9%	31.0%	33.4%
Repeat Business	97.0%	95.2%	94.7%	93.3%
DSO - TTM (in days)	65	65	63	64

Source: Company Reports

## Infosys Technologies

### Company description

Infosys is the second-largest IT services company in India with more than 66,000 professionals. It is among the fastest-growing IT services organization in the world and a leader in the offshore services space. Infosys provides business consulting, application development and maintenance and engineering services to more than 475 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 - used by leading banks in India, the Middle East, Africa and Europe. Its subsidiary, Infosys BPO (formerly Progeon), employing close to 10,000 people, provides BPO services. It launched a subsidiary in April 2004, Infosys Consulting, which provides high-end IT consulting services.

### Investment thesis

We rate Infosys as Buy/Low Risk (1L). We are positive on the stock from a fundamental 12-month view. Offshore IT outsourcing has now become a mainstream option, and we think scale and scalability, along with an ability to move up the value chain, are key criteria for successful offshore IT vendors. In this respect, Infosys appears well positioned and continues to gain given its strong branding and industry-leading sales force. We like companies such as Infosys that should see above-industry average volume growth along with some modest pricing improvement. We expect Infosys to deliver a revenue CAGR of 33.8% and EPS CAGR of 32.8% for FY06-09. Unlike many other high-growth firms in other industries, Infosys continues to generate solid FCF, and its RoE of 40%+ continues to be well above its cost of capital.

### Valuation

Our target price of Rs2,660 is based on a P/E of 28x on average FY08E-09E EPS. We forecast 34% earnings growth and upside potential from pricing improvement. The 28x multiple was also derived from a P/E band analysis of Infosys' trading pattern. During slowdowns in tech and offshore IT services, Infosys has traded at an average one-year rolling P/E of 25.1x with a low of 13x. Retrospectively, the average trading multiple of 25.1x is much lower because Infosys's earnings have consistently seen consensus upgrades on greater visibility and revisions in management guidance. At this stage of the growth cycle, we believe Infosys should trade in a band of 25-30x 12-month forward given the strong outlook for offshore IT services. Infosys has historically grown faster than the broader market (BSE Sensex) and traded at a premium of 40-135% (average of 84%) to the market. Our estimates continue to assume a P/E premium of 80% to the market; this is justified, in our view, given the strong FCF, ROIC and growth rates for Infosys vs. the overall market. We believe P/E remains the most appropriate valuation measure given Infosys's profitable track record and high earnings visibility.

### Risks

We rate Infosys shares as Low Risk, which is consistent with our quantitative risk-rating system that tracks historical share price volatility. The key downside risks to the shares reaching our target price include 1) any significant appreciation of the rupee against the US dollar/euro/pound; 2) pressure on billing rates (as Infosys continues to enjoy a 10-15% premium in its billing rates); 3) a sharp slowdown in the US economy; and 4) limited H1B visa quotas.

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## Tata Consultancy Services

### Company description

TCS is India's largest and among the oldest IT companies. It is part of the diversified TATA Group, one of the largest corporate groups in Asia. It has over 83,500 employees, including its subsidiaries, with marketing presence across 32 countries and development presence in 10 countries besides India. It provides comprehensive IT services to industries such as banking and financial services, insurance, manufacturing, telecommunications, retail and transportation. It has over 750 active clients at end of 3Q07 including six of the Fortune Top 10 companies in the US. The company started with data processing work in 1968, and was the first to provide offshore services in 1974.

### Investment thesis

We rate TCS Buy/Low Risk (1L) with a target price of Rs1,560 based on a fundamental 12-month view. As India's largest and most experienced IT services firm, TCS looks well positioned to benefit from the growing demand for offshore IT services. It is a well-regarded stock among investors familiar with India and the IT-services sector. We believe TCS' margins in its international IT services' business (around 95% of EBIT) are likely to trend down over the next few years. However, we expect this decline to be relatively modest, as we expect positive leverage from a) better onsite-offshore mix, b) higher fresher hiring, and c) improved utilization with strong demand outlook to offset margin pressure from wage inflation. Consequently, we expect revenue CAGR of 30.2% and EPS CAGR of 30.3% for FY06-09. We see upside to our estimates if large off-shoring deals materialize and/or a quicker-than-anticipated pickup in average pricing.

### Valuation

Our target price of Rs1,560 is based on a P/E of 26x FY08-09E average EPS, derived from a 7% discount to our target 28x FY08E-09E average earnings for Infosys - TCS' closest peer in terms of business model. We expect TCS to continue to trade at slightly lower multiples than Infosys due to its slower long-term growth and investors' greater comfort and familiarity with Infosys. Our target price assumes a one-year forward P/E of ~60% above the average BSE Sensex multiple, which we think is justified given TCS' superior FCF, RoIC and growth rates vs. the overall market, and it actually implies a slightly lower premium than that for Infosys. We believe P/E remains the most appropriate valuation measure given TCS' profitable track record and strong earnings visibility. Our target price is also supported by a FY08E Price/Sales multiple of 5x, which is within the stock's historical trading range of 3.5-5.5x since listing.

### Risks

We rate TCS Low Risk, consistent with our quantitative stock-volatility based risk rating system. Fundamentally also, given the stock's below-market beta, its relatively high earnings visibility, strong cash flows and balance sheet - along with our Low Risk rating for its local peers Infosys and Wipro - we believe a Low Risk rating for TCS makes sense. The key downside risks to our target price include: 1) Any significant appreciation of the rupee against the US Dollar/Euro/GBP; 2) A sharp slowdown in the US economy; 3) H1B visa quotas; 4) Large exposure to the GE Group; 5) Large exposure to fixed-price contracts; 6) TCS' higher onsite revenue contribution (~60% of total); and 7) Acquisition-related risks, including M&A with other Tata-group IT firms.



## Appendix A-1

### Analyst Certification

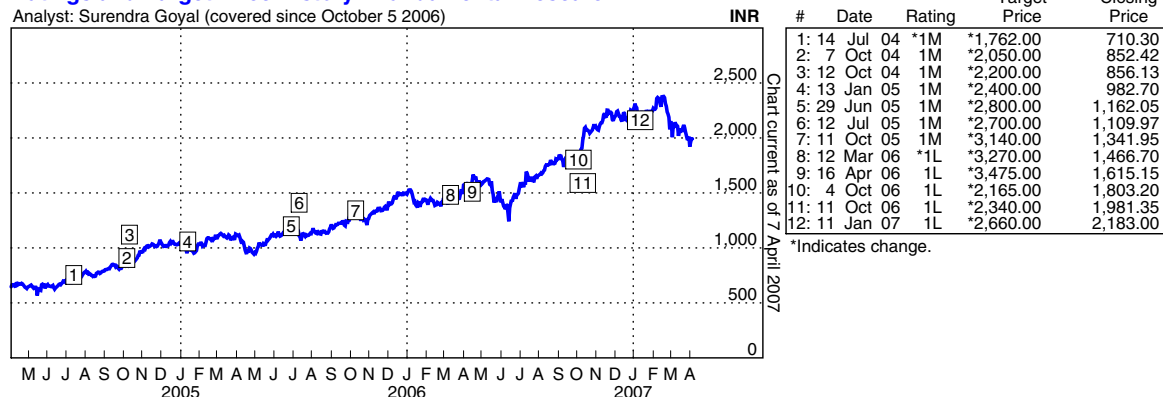
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##### Ratings and Target Price History - Fundamental Research

Analyst: Surendra Goyal (covered since October 5 2006)



— Covered  
 ..... Not covered

#### Tata Consultancy Services (TCS.BO)

##### Ratings and Target Price History - Fundamental Research

Analyst: Surendra Goyal (covered since October 5 2006)



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Medium to High Risk -- Mid Triple B through High Double B

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