

Company In-Depth

11 January 2007 | 11 pages

Infosys Technologies (INFY.BO)

Buy: Third Consecutive Quarter of Double-Digit Growth

 Rating change
 Target price change
 Estimate change

- Strong quarter normalizing for currency** — Infosys revenue grew 10.1% qoq in US\$ terms (5.9% in rupee terms). EBITDA margin increased 59bp qoq despite 3.8% rupee appreciation – primarily due to improvement in pricing, increase in offshore, lower SG&A and high product revenue.
- Strong pricing increase was big surprise** — Average revenue improved significantly - 1.7% qoq for offshore and 1.9% qoq for onsite. In 9M07, pricing has improved ~3.7% for onsite and ~2% for offshore. Company continues to get 3-4 % higher billing rate from new clients and 2-3% from existing clients.
- Muted guidance** — Fourth quarter guidance implies 4.9% growth (\$ terms) and 3.9% (Re terms) and EPS growth of 1.3% qoq. FY07 EPS (basic) guidance has been upgraded by ~1% to Rs66.63. Revised guidance is at Rs44.11/\$ (as against Rs45.6/\$ earlier).
- A few concerns** — Top-5 (ex top client) have shown 8.3% qoq decline – this coupled with declining revenue from travel and transportation vertical suggests client-specific issues with a major client from this vertical. Also, attrition continues to inch up – a likely industry-wide trend, in our view.
- Raise target price, Reiterate Buy (1L)** — We raise our pricing and volume estimates. However after adjusting for new forex rate from our economics team (Rs43.25/\$ for FY08E and Rs42.25/\$ for FY09E), our earning estimates remain largely unchanged. We raise our target price 14% to Rs2,660 as we maintain our target multiple of 28x and roll forward earnings to average FY08E-FY09E EPS. At current prices, Infosys trades at 25.8x FY08 and 20.8x FY09 earnings.

Buy/Low Risk	1L
Price (11 Jan 07)	Rs2,183.00
Target price	Rs2,660.00
	<i>from Rs2,340.00</i>
Expected share price return	21.9%
Expected dividend yield	0.7%
Expected total return	22.5%
Market Cap	Rs1,213,279M
	US\$27,295M

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



See page 9 for Analyst Certification and important disclosures.

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	63.5	22.6	44.6	0.4
2006A	24,599	43.82	27.5	49.8	17.2	40.4	1.0
2007E	37,672	66.27	51.2	32.9	11.7	43.4	0.5
2008E	48,320	84.74	27.9	25.8	8.5	39.0	0.7
2009E	59,929	105.10	24.0	20.8	6.3	35.5	0.8

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	63.5	49.8	32.9	25.8	20.8
EV/EBITDA adjusted (x)	50.8	38.1	25.9	19.6	15.4
P/BV (x)	22.6	17.2	11.7	8.5	6.3
Dividend yield (%)	0.4	1.0	0.5	0.7	0.8
Per Share Data (Rs)					
EPS adjusted	34.36	43.82	66.27	84.74	105.10
EPS reported	34.36	43.82	66.27	84.74	105.10
BVPS	96.73	126.60	186.17	257.84	347.33
DPS	8.00	22.50	12.00	15.00	18.00
Profit & Loss (RsM)					
Net sales	71,296	95,216	140,488	183,284	227,705
Operating expenses	-50,815	-68,669	-100,958	-132,146	-164,330
EBIT	20,481	26,547	39,530	51,138	63,375
Net interest expense	1,239	1,396	3,217	4,227	6,264
Non-operating/exceptionals	1	-11	-30	0	0
Pre-tax profit	21,721	27,932	42,717	55,365	69,639
Tax	-3,256	-3,132	-5,005	-7,045	-9,710
Extraord./Min.Int./Pref.div.	452	-201	-40	0	0
Reported net income	18,917	24,599	37,672	48,320	59,929
Adjusted earnings	18,917	24,599	37,672	48,320	59,929
Adjusted EBITDA	23,350	30,918	44,814	58,077	71,576
Growth Rates (%)					
Sales	46.9	33.5	47.5	30.5	24.2
EBIT adjusted	50.9	29.6	48.9	29.4	23.9
EBITDA adjusted	46.5	32.4	44.9	29.6	23.2
EPS adjusted	48.5	27.5	51.2	27.9	24.0
Cash Flow (RsM)					
Operating cash flow	6,956	31,118	36,799	48,013	59,956
Depreciation/amortization	2,869	4,371	5,284	6,939	8,201
Net working capital	-13,095	3,549	-2,800	-3,019	-1,910
Investing cash flow	-8,292	-10,890	-16,859	-11,673	-16,125
Capital expenditure	-8,292	-10,890	-16,859	-11,673	-16,125
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	1,291	-7,447	-4,153	-8,363	-10,036
Borrowings	0	0	0	0	0
Dividends paid	-4,303	-12,360	-6,677	-8,363	-10,036
Change in cash	-45	12,782	15,787	27,977	33,796
Balance Sheet (RsM)					
Total assets	67,513	93,800	129,621	176,870	235,379
Cash & cash equivalent	15,756	34,290	38,824	71,028	111,088
Accounts receivable	13,220	16,080	16,171	21,097	26,210
Net fixed assets	15,742	22,260	33,836	38,569	46,493
Total liabilities	14,326	23,460	25,822	33,115	41,730
Accounts payable	6,560	9,340	14,140	17,706	21,985
Total Debt	0	0	0	0	0
Shareholders' funds	53,188	70,340	103,799	143,755	193,649
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	32.8	32.5	31.9	31.7	31.4
ROE adjusted	44.6	40.4	43.4	39.0	35.5
ROIC adjusted	110.3	88.8	98.5	95.6	97.8
Net debt to equity	-29.6	-48.7	-37.4	-49.4	-57.4
Total debt to capital	0.0	0.0	0.0	0.0	0.0

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EBITDA margins up despite currency impact

EBITDA margins expanded by 60bp qoq despite the 200bp negative impact of currency appreciation (Re appreciated 3.8% qoq). The key factors offsetting the currency impact were:

- Pricing improvement of 140bp blended (margin impact of +80bp qoq)
- Higher product license revenues (margin impact of +80bp qoq)
- Lower SG&A (margin impact of +50bp qoq)

Pricing improvement – trend across the sector

Infosys witnessed a 5.1% onsite and 3.3% offshore realization increase on a yoy basis. On a sequential basis, the increase was 1.9% and 1.7% respectively. Management attributed it to change in business mix, new clients coming in at better prices and renegotiations with existing clients at higher prices. They also indicated that new clients were coming in at 3-4% higher rates and existing clients were giving 2-3% price increases.

While the quantum of price increases indicated by Infosys management is lower than peers TCS and Wipro, it clearly highlights that pricing trends are positive and are expected to continue to benefit these companies.

Large deals – Infosys reiterates strategy

Infosys reiterated its strategy of doing large deals only if they came at good price points. They said that they are open to large deals but do not want to compromise on pricing. In the past, they have talked about their intention of not locking in large deals at present rates. We believe that Infosys management reiteration of this strategy also highlights their bullish outlook on pricing going forward.

Management indicated that they had won 3-5 large deals in the quarter (\$70m+) and were pursuing 6-7 more \$100m deals.

Healthy headcount addition indicates strong business pipeline

Infosys has added 40% headcount in the last 12 months – which, in our view, highlights their optimism on the outlook going forward. This combined with decent price increases of ~2-3% should result in strong growth over the next 12 months.

Another quarter of 10%+ sequential growth in US\$ terms – third consecutive quarter

EBITDA margin expansion of 59bps was a positive surprise

Figure 1. Quarterly Financials

	3Q06	2Q07	3Q07	QoQ	YoY
Revenue (US\$ m)	524	746	821	10.1%	56.7%
Revenue	25,320	34,510	36,550	5.9%	44.4%
Cost of revenue	13,270	18,330	19,380	5.7%	46.0%
Gross profit	12,050	16,180	17,170	6.1%	42.5%
Gross margin	47.6%	46.9%	47.0%	9bp	-61bp
Operating expenses	3,440	5,090	5,210	2.4%	51.5%
EBITDA	8,610	11,090	11,960	7.8%	38.9%
EBITDA margin	34.0%	32.1%	32.7%	59bp	-128bp
Dep. and amort.	1,170	1,220	1,410	15.6%	20.5%
EBIT	7,440	9,870	10,550	6.9%	41.8%
EBIT margin	29.4%	28.6%	28.9%	26bp	-52bp
Other income	440	660	590	-10.6%	34.1%
Profit before tax	7,390	10,530	11,140	5.8%	50.7%
Income tax expense	830	1,230	1,300	5.7%	56.6%
Income from operations	6,560	9,300	9,840	5.8%	50.0%
Affiliates/Minority	-70	-10	-10	0.0%	-85.7%
Net income - recurring	6,490	9,290	9,830	5.8%	51.5%
EO income/(loss)	0	0	0	n.a.	n.a.
Net profit	6,490	9,290	9,830	5.8%	51.5%
EPS - basic	11.85	16.75	17.65	5.4%	48.9%
EPS - fully diluted	11.52	16.36	17.25	5.4%	49.7%

Source: Company Reports

EPS guidance revised 1% upwards despite 3.3% lower INR per USD assumption

Figure 2. Infosys Annual Guidance and Revision

Infosys	Revised Guidance		Implied growth		Revision	
	Lower	Upper	Lower	Upper	Lower	Upper
FY07 guidance						
Revenue (Rs m)	139,100	139,190	46.1%	46.2%	0.4%	0.1%
Revenue (\$ m)	3,090	3,090	43.6%	43.6%	2.0%	1.6%
EPS (Rs)	66.63	66.63	48.0%	48.0%	1.0%	1.0%
INR/USD assumption		44.11		-		-3.3%

Source: Company Reports

4Q07 guidance looks muted on currency appreciation and ESOP related dilution

Figure 3. Infosys 4Q07 Guidance

Infosys	Guidance		Implied growth	
	Lower	Upper	Lower	Upper
4Q07 guidance				
Revenue (Rs m)	37,890	37,980	3.7%	3.9%
Revenue (\$ m)	859	861	4.6%	4.9%
EPS (Rs)	17.88	17.88	1.3%	1.3%

Source: Company Reports

Attrition continues to inch up – management clarified that voluntary attrition moved up only 20bp from 12% to 12.2% last quarter. Involuntary attrition goes up as Infosys continues to focus on quality of new hires

Figure 4. Key HR Matrices

	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07
IT and BPO professionals	37,146	43,441	46,484	49,495	54,606	61,966	65,293
- Billable	34,611	38,541	39,494	42,604	48,438	53,873	58,073
- Banking Business Unit	1,328	1,351	1,677	1,863	1,817	1,809	1,967
- Trainees	1,207	3,549	5,313	5,028	4,351	6,284	5,253
Sales & support	2,660	2,755	2,938	3,220	3,803	4,184	4,039
Total employees	39,806	46,196	49,422	52,715	58,409	66,150	69,332
Gross addition	4,537	8,026	5,135	5,170	8,097	10,795	6,062
Net addition	3,056	6,390	3,226	3,293	5,694	7,741	3,282
Attrition % (TTM) - Infosys stand alone	9.8%	10.0%	10.0%	11.2%	11.9%	12.9%	13.5%
Utilization							
- including trainees	74.1%	72.9%	70.0%	69.7%	71.1%	67.5%	67.5%
- excluding trainees	77.5%	79.1%	78.7%	77.0%	76.1%	77.5%	75.8%

Source: Company Reports

Figure 5. Execution Matrices – Infosys Consolidated

	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07
Billed effort (person-months)	80,471	88,820	95,794	102,154	109,818	121,845	133,711
- Onsite	21,165	23,486	24,918	26,693	30,051	33,346	35,368
- Offshore	59,306	65,334	70,876	75,461	79,767	88,499	98,343
Billed effort distribution (%)							
- Onsite	26.3%	26.4%	26.0%	26.1%	27.4%	27.4%	26.5%
- Offshore	73.7%	73.6%	74.0%	73.9%	72.6%	72.6%	73.5%
Revenue distribution (%)							
- Onsite	47.9%	48.8%	48.6%	49.3%	50.5%	50.3%	49.2%
- Offshore	52.1%	51.2%	51.4%	50.7%	49.5%	49.7%	50.8%

Source: Company Reports

Figure 6. Execution Matrices – Consolidated IT Services

	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07
Billed effort distribution (person-months)	66,905	73,776	78,409	83,164	90,198	100,292	107,679
- Onsite	20,997	23,311	24,815	26,551	29,861	33,146	35,175
- Offshore	45,908	50,465	53,594	56,613	60,337	67,146	72,504
Billed effort distribution (%)							
- Onsite	31.4%	31.6%	31.6%	31.9%	33.1%	33.0%	32.7%
- Offshore	68.6%	68.4%	68.4%	68.1%	66.9%	67.0%	67.3%
Revenue distribution (%)							
- Onsite	52.0%	52.4%	52.4%	52.8%	52.5%	54.4%	54.4%
- Offshore	48.0%	47.6%	47.6%	47.2%	47.5%	45.6%	45.6%

Source: Company Reports

Europe continues to grow faster than other geographies

Figure 7. Revenue Mix - Geographic Distribution

	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07
North America	63.6%	65.4%	65.0%	65.0%	64.0%	63.7%	63.2%
Europe	23.9%	23.7%	24.9%	25.5%	26.2%	25.8%	26.8%
India	2.4%	1.5%	1.4%	1.8%	1.4%	1.6%	1.8%
RoW	10.1%	9.4%	8.7%	7.7%	8.4%	8.9%	8.2%
Total	100%	100%	100%	100%	100%	100%	100%

Source: Company Reports

Package implementation, Testing, BPO and Products have shown qoq growth

Figure 8. Revenue Mix – Service Line Distribution

	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07
Development	19.4%	19.9%	21.1%	20.1%	21.3%	21.4%	20.1%
Maintenance	30.4%	30.1%	29.5%	30.8%	29.9%	29.2%	29.8%
Re-engineering	5.1%	4.7%	5.0%	4.3%	2.6%	2.3%	2.1%
Package implementation	15.2%	15.8%	16.3%	17.1%	16.5%	17.0%	17.9%
Consulting	4.2%	3.8%	3.1%	3.2%	3.0%	3.6%	3.3%
Testing	6.5%	6.2%	5.5%	5.6%	6.2%	6.8%	7.0%
Engineering services	1.8%	1.9%	1.9%	1.9%	1.8%	1.6%	1.5%
Business process management	3.8%	3.9%	4.0%	4.0%	4.2%	4.5%	4.9%
Other services	9.0%	10.1%	9.8%	9.8%	10.8%	9.9%	9.1%
Total services	95.4%	96.4%	96.2%	96.8%	96.3%	96.3%	95.7%
Products	4.7%	3.6%	3.8%	3.2%	3.7%	3.7%	4.3%
Total	100%	100%	100%	100%	100%	100%	100%

Source: Company Reports

Insurance and retail verticals have growth 25%+ qoq

Figure 9. Revenue Mix – Vertical Distribution

	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07
Insurance	8.4%	7.9%	7.0%	6.8%	7.0%	6.7%	7.6%
Banking & FS	27.9%	27.8%	29.0%	29.2%	29.4%	30.7%	31.0%
Manufacturing	13.3%	13.5%	14.1%	14.5%	14.5%	14.0%	12.8%
Retail	9.6%	10.5%	10.3%	10.2%	9.7%	9.0%	10.5%
Telecom	17.2%	16.7%	15.8%	16.3%	17.7%	18.9%	18.3%
Energy & Utilities	3.7%	4.3%	5.3%	5.3%	5.4%	5.6%	5.4%
Transportation & Logistics	7.0%	5.6%	4.5%	3.6%	3.3%	2.7%	2.0%
Services	9.4%	9.9%	9.8%	9.6%	8.7%	7.7%	8.3%
Others	3.5%	3.8%	4.2%	4.5%	4.3%	4.7%	4.1%
Total	100%	100%	100%	100%	100%	100%	100%

Source: Company Reports

Transportation and Logistics have shown steady decline over last several quarters

Figure 10. Client Relationships

	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07
Active Clients	443	450	454	460	469	476	488
Added during the quarter	36	34	36	38	38	45	43
No. of million dollar clients	172	191	206	221	221	232	256
No. of 5mn+ dollar clients	73	76	78	81	94	97	108
No. of 10mn+ dollar clients	43	48	51	54	56	61	67
No. of 20mn+ dollar clients	22	23	25	26	28	29	35
No. of 30mn+ dollar clients	14	16	18	19	19	20	22
No. of 40mn+ dollar clients	8	11	14	14	15	16	17
No. of 50mn+ dollar clients	5	6	7	9	11	12	11
No. of 8mn+ dollar clients	1	1	2	0	3	3	4
No. of 100mn+ dollar clients	0	0	0	0	2	2	2
Revenue - top client	5.2%	4.4%	4.5%	4.7%	5.8%	6.6%	6.9%
Revenue - top 5 client	19.1%	17.8%	17.6%	18.6%	19.5%	21.0%	18.9%
Revenue - top 10 client	31.8%	30.6%	29.9%	31.0%	31.7%	32.9%	31.0%
Repeat Business	98.7%	96.5%	93.2%	92.1%	97.0%	95.2%	94.7%
DSO - TTM (in days)	59	59	57	62	65	65	63

US\$1m clients have increased by 24 qoq while US\$5m+ have increased by 11

Top2-5 clients have declined qoq

Source: Company Reports

Infosys Technologies

Company description

Infosys is the second-largest IT services company in India with more than 69,000 professionals. It is also 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 480 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 - that is used by leading banks in India, the Middle East, Africa and Europe. Its subsidiary, Infosys BPO (formerly Progeon), which employs over 10,000 people, is a provider of BPO services. It launched a subsidiary in April 2004, Infosys Consulting, which provides high-end IT consulting services.

Investment thesis

We rate Infosys shares 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 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

We raise our target price to Rs2,660 from Rs2,340 as we maintain our target multiple of 28x and roll forward earnings to average FY08E-FY09E EPS.

Our target price of Rs2,660 is based on a P/E of 28x on average FY08E-09E EPS (previously just FY08E). 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.

Risk

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.

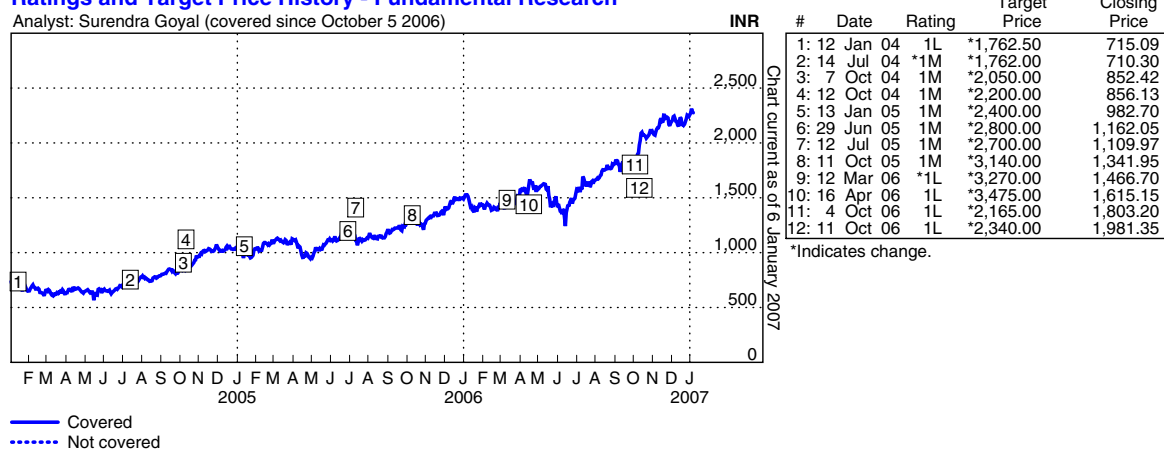
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Analyst: Surendra Goyal (covered since October 5 2006)



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