

## Company Focus

5 January 2009 | 10 pages

# Infosys Technologies (INFY.BO)

Target price change   
Estimate change

## Buy: Previewing Q3; Cutting Estimates Again

- Expect a difficult Q3** — We expect revenues at \$1,167m (guidance of \$1,175-\$1,220m), down ~4% qoq. This assumes marginal decline in volumes, stable pricing and ~4% impact of cross currency. EBIT margins are expected to fall ~150bps qoq. We forecast basic EPS of Rs26.63 in line with guidance.
- Volumes continue to be under pressure; pricing could follow** — Volumes continue to be under pressure with clients cutting back on discretionary projects and Q3 being also impacted due to “holiday project closures”. We expect pricing pressure to start being visible Q4 onwards for the industry. We are modeling in ~4-5% pricing decline for FY10E.
- Trim estimates by ~6%; new target of Rs1,350** — We have lowered our FY10-11E estimates by ~6% on the back on lower volume/pricing assumptions and cross currency impact in Q3. Consensus estimates for FY10 are ~6% higher than ours – we see consensus revisions ahead.
- Is it all in the price?** — While the stock price witnessed ~37% erosion in CY08, our new numbers are ~6% below consensus, and we expect consensus to be revised down further. This could put further pressure on the stock in the near term. Our EPS numbers benefit from ~5% INR depreciation assumed in FY09 – in other words, we are modeling an EPS decline in constant currency terms.
- Why Infosys remains our only Tier-I Buy?** — With a likely result disappointment and further EPS cuts, stock could underperform near term. However, Infosys remains our only Buy in the Tier-I space due to: (1) Ability to manage costs better; (2) Flight to safety likely to continue benefiting Infosys, particularly given issues in Satyam recently; (3) Historic low valuations at ~11x FY10E.

<b>Buy/Medium Risk</b>	<b>1M</b>
Price (02 Jan 09)	Rs1,136.50
Target price	Rs1,350.00
	<i>from Rs1,420.00</i>
Expected share price return	18.8%
Expected dividend yield	2.6%
<b>Expected total return</b>	<b>21.4%</b>
Market Cap	Rs650,646M
	US\$13,347M

### 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)	(%)	(%)
2007A	38,560	67.76	54.6	16.8	5.7	42.3	1.0
2008A	46,590	81.26	19.9	14.0	4.7	37.2	2.9
2009E	57,888	100.93	24.2	11.3	3.6	36.6	2.6
2010E	59,518	103.77	2.8	11.0	2.9	29.8	2.6
2011E	60,320	105.17	1.3	10.8	2.5	25.0	2.8

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
<b>Valuation Ratios</b>					
P/E adjusted (x)	16.8	14.0	11.3	11.0	10.8
EV/EBITDA adjusted (x)	13.7	11.2	8.2	7.4	6.6
P/BV (x)	5.7	4.7	3.6	2.9	2.5
Dividend yield (%)	1.0	2.9	2.6	2.6	2.8
<b>Per Share Data (Rs)</b>					
EPS adjusted	67.76	81.26	100.93	103.77	105.17
EPS reported	67.76	81.26	100.93	103.77	105.17
BVPS	199.99	241.11	311.43	385.40	458.78
DPS	11.50	33.25	30.00	30.00	32.00
<b>Profit &amp; Loss (RsM)</b>					
Net sales	138,930	166,920	215,520	233,144	251,343
Operating expenses	-100,160	-120,520	-154,348	-168,264	-183,630
<b>EBIT</b>	<b>38,770</b>	<b>46,400</b>	<b>61,172</b>	<b>64,880</b>	<b>67,713</b>
Net interest expense	3,720	7,040	6,156	7,070	10,282
Non-operating/exceptionals	-20	0	0	0	0
<b>Pre-tax profit</b>	<b>42,470</b>	<b>53,440</b>	<b>67,328</b>	<b>71,950</b>	<b>77,994</b>
Tax	-5,110	-6,850	-9,440	-12,432	-17,674
Extraord./Min.Int./Pref.div.	1,200	0	0	0	0
<b>Reported net income</b>	<b>38,560</b>	<b>46,590</b>	<b>57,888</b>	<b>59,518</b>	<b>60,320</b>
Adjusted earnings	38,560	46,590	57,888	59,518	60,320
Adjusted EBITDA	43,910	52,380	69,095	72,894	75,967
<b>Growth Rates (%)</b>					
Sales	45.9	20.1	29.1	8.2	7.8
EBIT adjusted	46.0	19.7	31.8	6.1	4.4
EBITDA adjusted	42.0	19.3	31.9	5.5	4.2
EPS adjusted	54.6	19.9	24.2	2.8	1.3
<b>Cash Flow (RsM)</b>					
<b>Operating cash flow</b>	<b>29,100</b>	<b>41,490</b>	<b>51,197</b>	<b>53,974</b>	<b>58,773</b>
Depreciation/amortization	5,140	5,980	7,923	8,014	8,254
Net working capital	-9,410	-3,770	-8,288	-6,488	480
<b>Investing cash flow</b>	<b>-20,590</b>	<b>-16,040</b>	<b>-14,135</b>	<b>-10,930</b>	<b>-12,161</b>
Capital expenditure	-20,590	-16,040	-14,135	-10,930	-12,161
Acquisitions/disposals	0	0	0	0	0
<b>Financing cash flow</b>	<b>5,000</b>	<b>-21,230</b>	<b>-17,569</b>	<b>-17,173</b>	<b>-18,318</b>
Borrowings	0	0	0	0	0
Dividends paid	-6,432	-19,018	-17,173	-17,173	-18,318
<b>Change in cash</b>	<b>13,510</b>	<b>4,220</b>	<b>19,493</b>	<b>25,871</b>	<b>28,295</b>
<b>Balance Sheet (RsM)</b>					
<b>Total assets</b>	<b>134,090</b>	<b>179,860</b>	<b>216,303</b>	<b>260,735</b>	<b>308,228</b>
Cash & cash equivalent	58,710	69,500	95,870	128,811	167,388
Accounts receivable	24,360	32,970	39,919	46,629	50,269
Net fixed assets	37,710	47,770	53,981	56,898	60,804
<b>Total liabilities</b>	<b>21,500</b>	<b>41,910</b>	<b>38,034</b>	<b>40,120</b>	<b>45,611</b>
Accounts payable	14,690	19,120	24,727	25,318	27,615
Total Debt	0	0	0	0	0
<b>Shareholders' funds</b>	<b>112,590</b>	<b>137,950</b>	<b>178,269</b>	<b>220,615</b>	<b>262,617</b>
<b>Profitability/Solvency Ratios (%)</b>					
EBITDA margin adjusted	31.6	31.4	32.1	31.3	30.2
ROE adjusted	42.3	37.2	36.6	29.8	25.0
ROIC adjusted	83.6	66.3	70.1	61.2	54.3
Net debt to equity	-52.1	-50.4	-53.8	-58.4	-63.7
Total debt to capital	0.0	0.0	0.0	0.0	0.0

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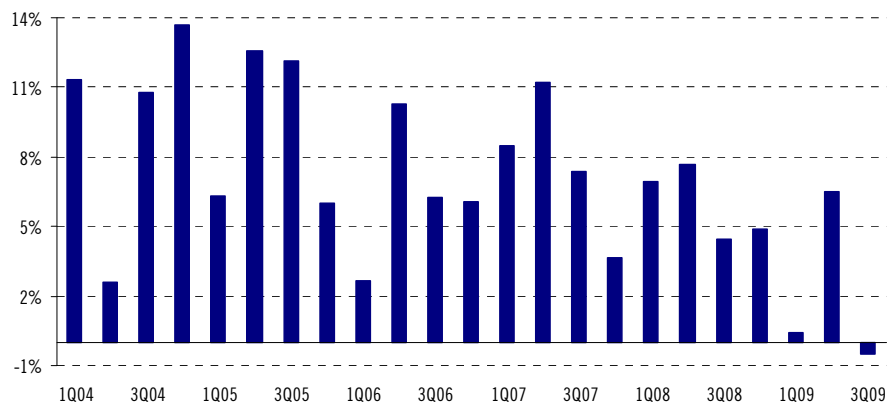


## Negative volume growth in Q3 likely

We expect a muted Q3 with volumes expected to decline marginally by ~0.5%. This will largely be due to pressure on discretionary spend, delays in ramp up of new projects and “holiday closures” in December.

Figure 1. Volume Growth Since 1QFY04

We expect negative volume growth for the 1<sup>st</sup> time in more than five years



Source: Citi Investment Research

## Margins expected to fall ~150bps

We expect EBIT margins to decline ~150bps in Q3 primarily on account of:

- Lower utilization – We forecast utilization ex-trainees to dip by ~300bps. The number of trainees will continue to be high as the hiring in the quarter will be largely trainees.
- Cross currency impact – Currency impact should impact US\$ term revenue growth by ~4%. While Infosys had built ~100bp in the guidance, the additional will continue to weigh down on margins.
- Investments in solutions etc – Infosys management has indicated in the past that they will maintain margins in a narrow band and reinvest the benefits of currency back into the business. There could be accelerated investments into solutions and other initiatives in this quarter.
- Increase in depreciation by ~50bps qoq.
- Positive impact of INR/USD – Infosys had guided at Rs46.97/\$ while we model using Rs48.5/\$ – this should be a positive on margins (~120bp).

Currency movements in Q3 have been very sharp leading to cross currency headwinds for the reported US\$ term growth

Figure 2. Currency Movements

	2QFY09	3QFY09	Change (diff)	Change (%)
<b>USD / INR</b>				
Period end	46.82	48.62	-1.81	3.9%
Average	43.71	48.59	-4.87	11.2%
<b>GBP / USD</b>				
Period end	1.78	1.46	0.32	-18.0%
Average	1.89	1.57	0.32	-17.1%
<b>EUR / USD</b>				
Period end	1.41	1.40	0.01	-0.9%
Average	1.50	1.32	0.19	-12.3%

Source: DataStream

## Revising estimates by 0-6%

We have revised our estimates over FY09-11E by ~0-6% to account for lower volume/pricing assumptions and the severe cross currency impact witnessed in Q3. Our FY11 estimates have also been negatively impacted due to a higher tax rate assumption – given that very little work will be shifted to SEZs given the sluggish volume growth outlook over the next couple of years.

Figure 3. Infosys Estimates Revisions

FYE	Net Profit (RsM)	EPS (Rs)	% chg	DPS (Rs)
31 Mar				
2009E	57,888	100.93	-0.4	30.00
Prev	58,148	101.38		25.00
2010E	59,518	103.77	-5.0	30.00
Prev	62,640	109.21		30.00
2011E	60,320	105.17	-5.5	32.00
Prev	63,838	111.30		35.00

Source: Citi Investment Research estimates

Infosys is our only Buy in the Tier-I IT Services space

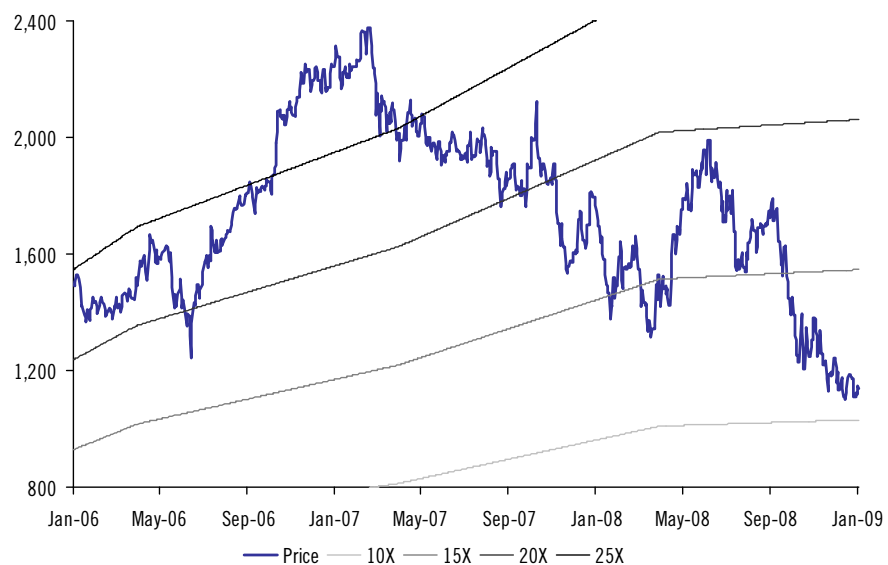
## Target Rs1,350 – remains our only Tier-I Buy

We have cut our target price to Rs1,350 (from Rs1,420) to factor in the lowered estimates.

While there could be a negative short-term impact given the weak quarterly outlook, Infosys remains our only Buy in the Tier-I IT Services space due to:

- Superior cost management ability of Infosys management as demonstrated by its track record. From FY04-08, Infosys managed stable margins (decline of ~17bps) in a high wage inflation scenario. In the same period competitors lost ~220-290bps in EBIT margins.
- Flight to safety likely to continue given that scale players are likely to fare better than smaller players in this environment, there is flight to better balance sheets, and the recent issue at Satyam will likely benefit Infosys, from a stock perspective.
- The stock trades at ~11x FY10E on our lowered estimates (and ~10x FY10E on street estimates) – which is at historic lows. Near-term outlook remains challenging – but we continue to believe Infosys is best positioned to handle the crisis within its peer group.

Figure 4. Infosys 12-Month Forward PE Band Chart



Source: Citi Investment Research

# Infosys Technologies

## Company description

Infosys is the second-largest Indian IT services company with more than 100,000 professionals, and is a leader in the offshore services space. Infosys provides business consulting, application development & maintenance and engineering services to ~600 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, Middle East, Africa and Europe. Its subsidiary, Infosys BPO, which employs more than 17,000 people, is a provider of BPO services.

## Investment strategy

We rate Infosys shares as Buy / Medium Risk (1M). We are positive on the fundamentals of the company. Offshore IT outsourcing has now 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 revenue CAGR of ~9% (US\$ terms) and earnings CAGR of ~9% for FY08-11E. Unlike many other high-growth firms in other industries, Infosys continues to generate solid FCF and its RoE of 30%+ continues to be well above its cost of capital.

## Valuation

Our target price of Rs1,350 is based on 13x FY10E EPS. This is close to the lower end of the last three-year trading band of 11-30x 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

Although our quantitative risk-rating system suggests High Risk, we rate Infosys shares as Medium Risk given the superior branding, management quality and cost optimization abilities. The key downside risks are: (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. Any of these risk factors could impede the shares from reaching our target price.

# Appendix A-1

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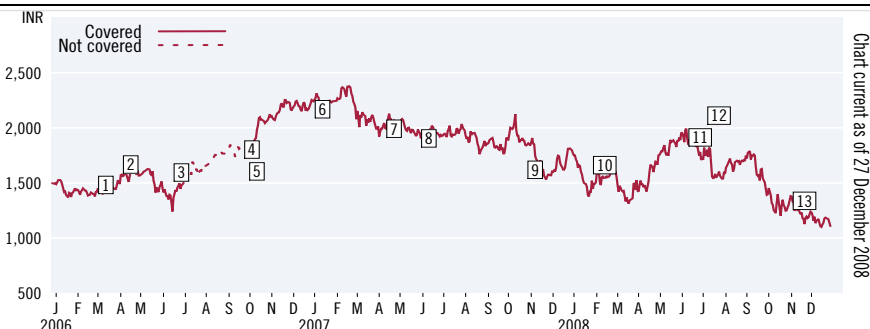


Chart current as of 27 December 2008

	Date	Rating	Target Price	Closing Price
1	13-Mar-06	*1L	*1,635.00	1,466.70
2	17-Apr-06	1L	*1,737.50	1,615.15
3	27-Jun-06	Coverage suspended		
4	4-Oct-06	1L	*2,165.00	1,803.20
5	11-Oct-06	1L	*2,340.00	1,981.35

	Date	Rating	Target Price	Closing Price
6	11-Jan-07	1L	*2,660.00	2,183.00
7	23-Apr-07	1L	*2,580.00	2,067.55
8	10-Jun-07	1L	*2,440.00	1,951.05
9	7-Nov-07	1L	*2,190.00	1,743.85
10	13-Feb-08	*1M	*2,060.00	1,549.15

	Date	Rating	Target Price	Closing Price
11	26-Jun-08	1M	*2,175.00	1,781.85
12	23-Jul-08	1M	*1,910.00	1,603.70
13	20-Nov-08	1M	*1,420.00	1,127.25

\* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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