

Infosys

Are we still convinced?

Infosys has consistently disappointed the street for almost 6 quarters now. By any stretch of the imagination that is a long wait for a company like Infosys to deliver and it has tested investor's patience on the resumption of growth. However post Q1FY13 we are incrementally convinced that growth will resume sooner rather than later. Our core thesis has been that we are seeing Infosys become more flexible on price and less averse to risk in the commoditized area of the business, in an effort to drive volume growth and boost utilization rates which are now close to historic lows. Q1FY13 results build on our thesis with volume growth at 3% v/s street expectations of flat volumes. The decline in pricing is largely like-for-like and broad based which indicates that better volume growth and improving utilization will follow. We reiterate BUY.

Expect improved focus on commodity biz to yield results

In our recently published initiation thematic, our key investment argument for Infosys was that it was back on twin engines - the commodity (ADM) segment as well as the high margin (consulting and SI) segment - after realising that it had lost sight of near term realities. While revenues in this quarter were held back due to cancellation of a transformational project, the concern is can Infosys get back to top quartile growth rates of the past? We continue to think so:

- 1. Pricing decline should drive volume growth:** We understand that Infosys has seen a like-for-like pricing decline of at least 2% QoQ after adjusting for i) cross currency (60bp) and ii) \$15m impact due to cancellation of a transformational project by an European Utility firm (80bp) and iii) shift in portfolio mix (20bps). We believe that large scale pricing re-negotiations in key accounts has happened, which led to 2% like for like drop in pricing which will eventually drive volumes in H2FY13. While it is well placed to drive growth when the environment improves, we see increasing realisation within Infosys that it can no longer lose share in the commodity segment.
- 2. 5% growth guidance builds in possible future ramp downs:** Given two back to back misses in quarterly revenues and discontinuation of quarterly guidance, a genuine concern is whether "at least 5%" growth is possible or even that is at risk now. Our conversation with the company indicates that the revenue growth guidance of 5% in FY13 factors adequate ramp downs in the BFS segment (if at all) in H2FY13. Infosys has been mentioning that some BFS clients could relook at their budgets in H2 of CY12 and it has identified problem accounts and has built in adequate provision in those accounts in arriving at 'at least' 5% revenue growth for the full year.
- 3. Margin to improve with growth; wage hike only if growth improves:** We expect margins to improve with increasing volume growth (we estimate 10% headroom to utilization over time). Our expectations of improving volume growth are predicated on the broad based pricing declines driving share gains. Conversations with the company also indicate that wage hikes are unlikely in FY13 until there is a significant improvement in growth.

Valuation: Why give 14x multiple when growth is 5%?

Our view of a re-rating in multiples for Infosys is driven by our conviction of improving growth. We note that in the past volume growth returned post decline in pricing. For instance growth in FY10 picked up after two consecutive quarters of pricing declines (pricing fell by 6% and 3% in Q3 and Q4FY09 respectively). With revenue decline and price cut already in place, we expect revenue growth to gather steam. Reiterate **BUY**.

Accounting & corporate governance	GREEN
Franchise Strength	GREEN
Earnings Momentum	GREEN

BUY

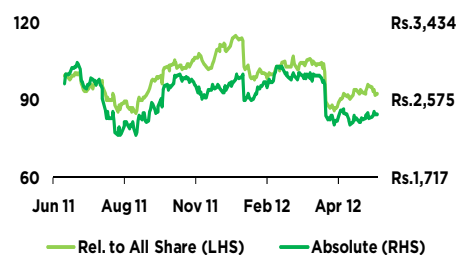
24% upside

Fair Value (Rs)	2,820
Bloomberg Code	INFO IN
Share Price (Rs)	2,265
Market Cap (Rs bn / \$ m)	\$24bn/Rs1,300
Free Float / FII holding	84% / 39%
ADV (Rs m / \$m)	\$80m / Rs 4.5bn

Rs m (unless stated) March YE	2011A	2012E	2013E	2014E
Total Income	275,010	337,344	394,717	429,565
EBITDA	89,640	107,164	120,476	134,511
PAT	68,314	83,314	92,674	103,274
EPS (Rs)	119.51	145.56	162.25	180.81
FCF	51,290	72,800	68,870	72,878

X (unless stated)	2011A	2012E	2013E	2014E
P/E	19.0	15.6	14.0	12.5
EV/Sales	4.1	3.2	2.7	2.3
EV/EBITDA	12.6	10.2	8.8	7.4
EV/EBIT	13.9	11.1	9.7	8.2

Figure 1 Historical share price performance



Source: Bloomberg

Analyst

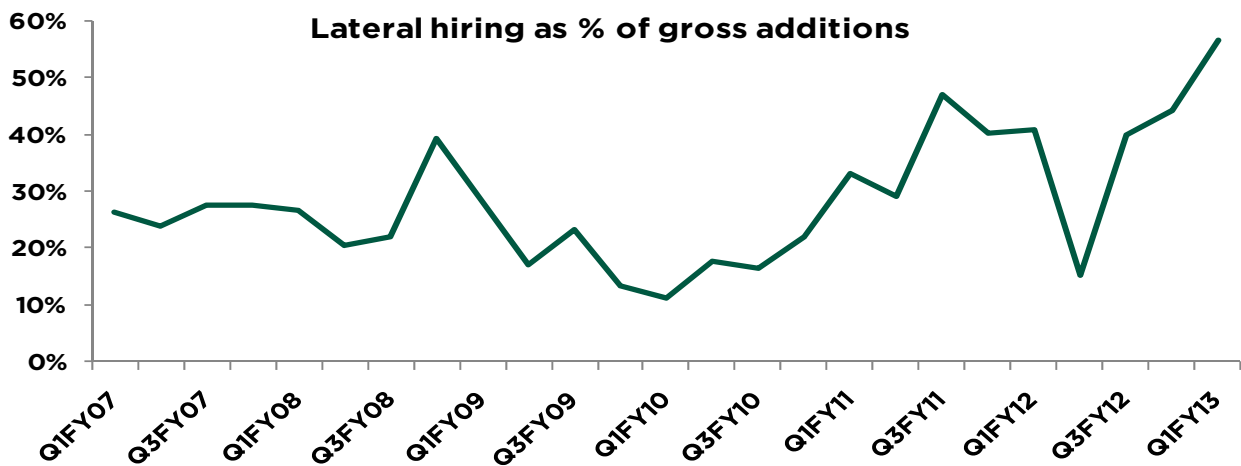
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Down but not out...

We see volume growth returning for Infosys and expect revenue growth to converge with TCS by Q3FY13. Infosys' has been aggressively addressing its volume growth issues by i) ring fencing existing large accounts by proactively offering lower total cost of ownership, ii) becoming more flexible on price to win large deals and iii) becoming less averse to contractual risks and managing these risks at the back end. Proactively offering lower total cost of ownership to clients need not necessarily translate into pricing declines as the endeavour is to convert these projects into fixed price projects. Fixed price projects imply that execution risk moves to the vendor. Execution risks are typically covered by hiring more laterals to minimize risk. Infosys' lateral hiring in the current quarter at 57% of overall hires is the highest in history. We have already seen pricing declines. We now expect to see the percentage of fixed price projects increasing. We believe this effort will not only improve revenue productivity but also aid margins over time.

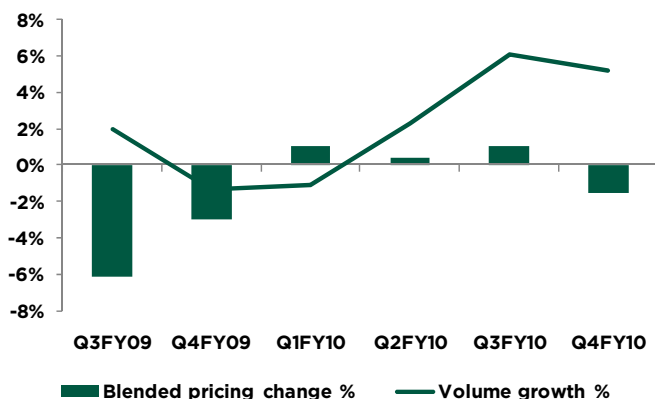
Figure 2 Lateral hiring at 57% of gross additions - highest in history



Source: Company, Espirito Santo Investment Bank estimates

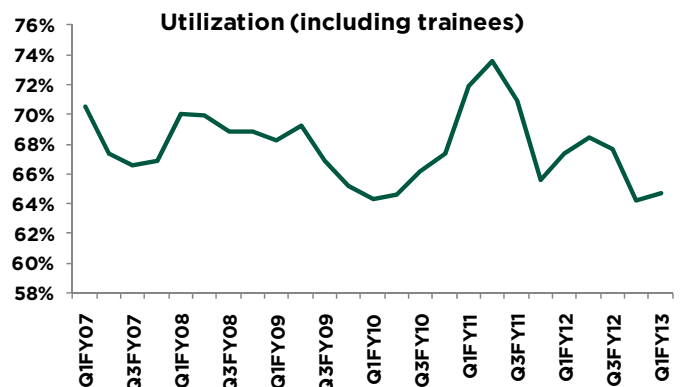
Correlation between volume and pricing is visible in figure 3. In Q1 and Q2 FY09, Infosys revenue declined 4% each which was followed by 6% and 3% billing rate cut in Q3 and Q4FY09. While revenues remained flat in Q1FY10, it increased to 5% CQGR over next three quarters. This time too we have seen revenue and pricing decline and we now expect revenue growth to resume. Additionally, utilisation rates also jumped during this time frame Q2 to Q4FY10 which aided margins. Utilization rates are at historic lows and it should improve along with revenue growth.

Figure 3 Volumes and pricing: Volumes picks up after lag of 2 quarters



Source: Company, Espirito Santo Investment Bank Research

Figure 4 Improving volumes should lead to higher utilization rates



Source: Company, Espirito Santo Investment Bank

Business model - Infosys has three key service offerings

Infosys is the second largest but best known Indian IT services firm. It focuses on providing offshore IT services primarily delivered from India to Western firms. Infosys has historically displayed the strongest organic growth and margin performance aided by a premium pricing strategy. Its clients include several Fortune 500 firms.

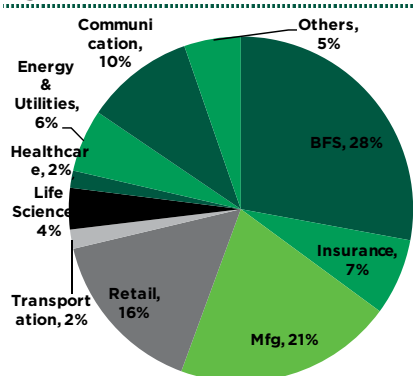
- Business operations:** This is Run The Business (RTB) segment of Infosys which includes ADM, IMS, Testing, BPM and PES. Business Operations contributes to 63% of revenues and is headed by Chandrasekhar Kakal who prior to reorganization was heading Enterprise Services.
- Consulting and Systems Integration:** This is Transform The Business (TTB) segment of Infosys which includes Consulting and Package Implementation contributing to 31% of total revenues. This segment is headed by Stephen Pratt.
- Products, Platforms and Solutions:** This is Grow The Business (GTB) segment of Infosys which includes Products (mainly Finacle) and platform offerings. Finacle (Infosys's Core Banking Product) is head by its CFO.

Table 1 Infosys Fact Sheet

Parameter	Number
Revenue FY12	\$7.0bn
Employees	150000
Revenue per employee	\$46,650
Key Markets	
US	64% of sales
Europe	22% of sales
Asia Pacific	14% of sales
Key Segments	
Financial Services	35% of sales
Manufacturing	21% of sales
Total Clients	694
Top 10 client contrib.	25% of sales
\$100m + clients	13

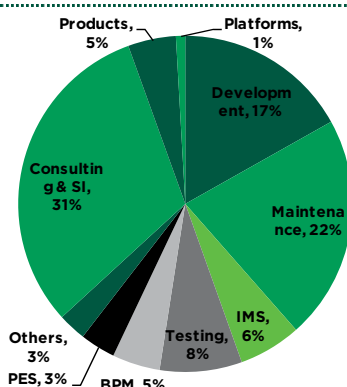
Source: Company

Figure 5 Vertical wise revenue Mix



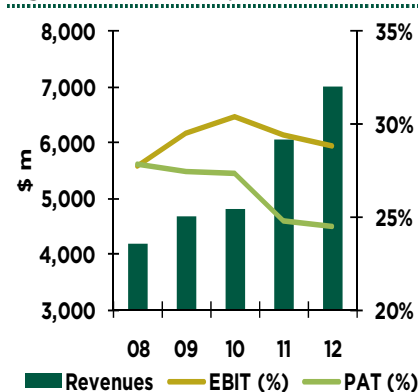
Source: Company, Espirito Santo Investment Bank research

Figure 6 Horizontal wise revenue Mix



Source: Company, Espirito Santo Investment Bank research

Figure 7 Revenue, EBIT and PAT



Source: Company, Espirito Santo Investment Bank research

Key risk and sensitivities

Table 2 Scenario analysis

	High case	Base case	Low case
Price target	Rs.3,150	Rs.2,820	Rs. 2,200
Upside/downside:	39% upside	24% upside	3% downside
Assumptions	<ul style="list-style-type: none"> Revenue growth of 16% in next 3 years, followed by 11% for next 5 years and 7% for next 7 yrs Margin decline of 25 bps/ yr 	<ul style="list-style-type: none"> Revenue growth of 13% in next 3 years, followed by 9% for next 5 years and 6% for next 7 years Margin decline of 50 bps each year 	<ul style="list-style-type: none"> Revenue growth of 10% in next 3 yrs, followed by 8% for next 5 years and 4% for next 7 years Margin decline of 100 bps/ yr

Source: Espirito Santo Investment Bank research

Change in estimates

Our have largely retained our revenue estimates for FY13 and FY14. However, we have cut our EBITDA estimates by 2% for FY13 and 3% for FY14 to factor lower growth and drop in pricing. Our EPS estimates for FY13 and FY14 have thus come off due to changes in EBITDA.

Table 3 Changes to estimates

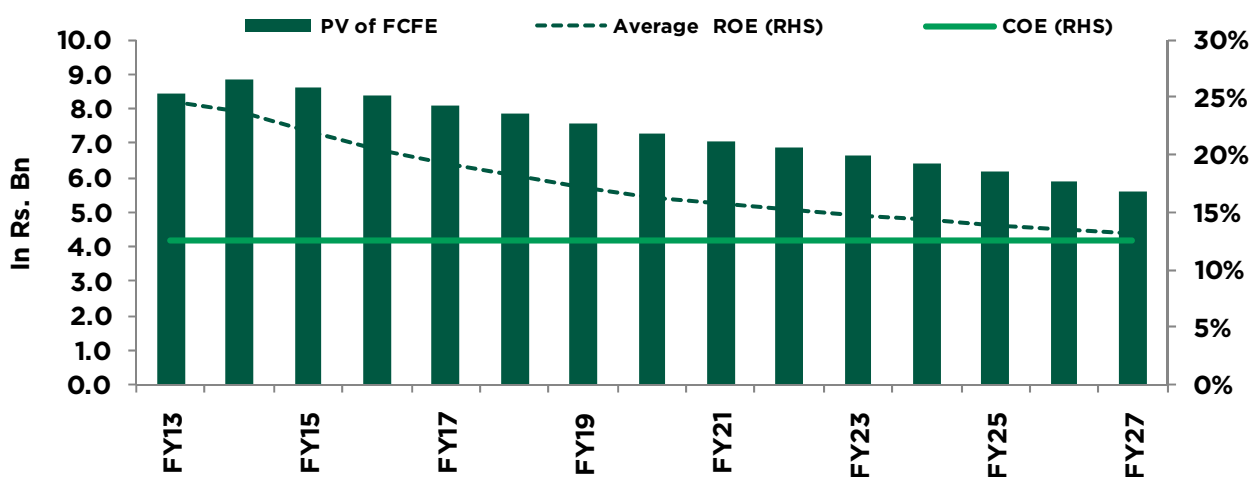
(Rs m)	Old	New	Change %
Sales			
FY13	394,248	394,717	0%
FY14	435,555	429,565	(1%)
EBITDA			
FY13	122,723	120,476	(2%)
FY14	138,972	134,511	(3%)
EPS (Rs)			
FY13	163.18	162.25	(1%)
FY14	187.09	180.81	(3%)

Source: Bloomberg, ESIB inc Execution Noble

Valuation: stock pricing in only negatives

Infosys has clearly underperformed on investor's expectations in the last six quarters owing to execution issues related to reorganization and company's view around commoditized business. During this period, a few clients decided to part ways which has aggravated the lower revenues' trajectory. However, we see a sense of acceptance within the company that they cannot let go of their core business and just focus on consulting and SI. Our interactions with primary data sources too indicate that things are nearing an end and most of the execution issues have now been sorted out. Our DCF based valuation falls marginally (3%) to Rs. 2,820. At 14x FY13e (vs. 5 year average of 18.2x forward earnings, and TCS currently at 18.2x) we reiterate BUY.

Figure 8 Infosys FCFE Profile



Source: Espirito Santo Investment Bank estimates

Figure 9 DCF Summary

Category	Last Published	Current	Change
COE	12.5%	12.5%	0%
Terminal Growth Rate	2.5%	2.5%	0%
PV of growth phase	25,855	25,754	0%
PV of consolidation	39,149	36,225	(7%)
PV of maturation	44,615	42,700	(4%)
PV of terminal value	57,173	56,442	(1%)
DCF of equity value	166,792	161,120	(3%)
Net Cash			
Total Equity Value	166,792	161,120	(3%)

Figure 10 DCF Sensitivity

Terminal Growth	WACC				
	10.5%	11.5%	12.5%	13.5%	14.5%
0.5%	3,348	2,957	2,639	2,376	2,155
1.0%	3,421	3,010	2,678	2,405	2,178
1.5%	3,502	3,069	2,721	2,437	2,202
2.0%	3,593	3,133	2,768	2,472	2,228
2.5%	3,695	3,205	2,820	2,510	2,257
3.0%	3,810	3,285	2,877	2,552	2,287
3.5%	3,942	3,375	2,940	2,597	2,321
4.0%	4,095	3,477	3,011	2,648	2,358
4.5%	4,272	3,594	3,091	2,704	2,398

Risk to our call

The key risks to our call are i) significant deterioration in macro that could probably lead to a discontinuation of guidance altogether and ii) any significantly negative outcome in the visa case that could constrain Infosys from conducting normal business in the United States (in such an event this could impact the entire sector).

Summary Financials (All figures in Rsmn, year ends in March)

Infosys

Recommendation: **BUY**

Fair Value: **INR 2820**

Share Price:	2,265
Upside / Downside	24%
3 Month ADV (\$m)	80
Free Float	84.0%
52 Week High / Low	INR 3,020 - 2,169

Bloomberg: INFO IN
Model Published On: 13 July 2012

Shares In Issue (mm)	571
Market Cap (\$mn)	23,530
Net Debt (\$mn)	-3,744
Enterprise Value (\$mn)	19,786

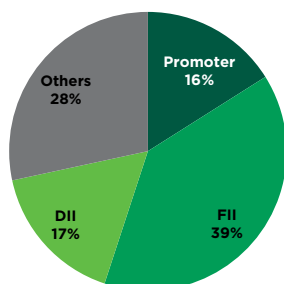
Forthcoming Catalysts

Visa misuse hearing 20 August 2012

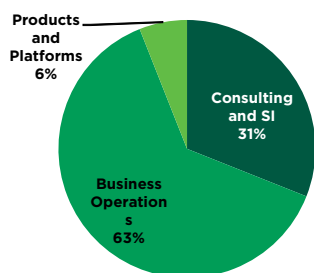
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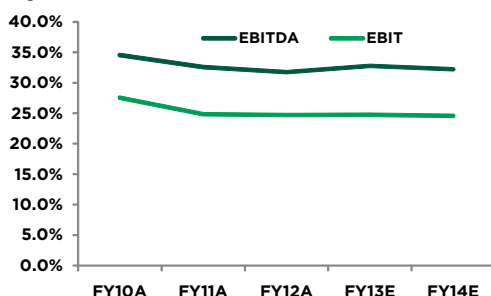
Shareholding Pattern



Revenue Breakdown



Margin Trends



Valuation Metrics	2009A	2010A	2011A	2012A	2013E	2014E
P/E	21.6	20.7	19.0	15.6	14.0	12.5
Reported P/E	21.6	20.7	19.0	15.6	14.0	12.5
EV / Sales	5.5	5.2	4.1	3.2	2.7	2.3
EV / EBITDA	16.6	15.1	12.6	10.2	8.8	7.4
EV / EBIT	18.6	17.1	13.9	11.1	9.7	8.2
FCF Yield	3.2%	4.2%	3.6%	4.9%	4.5%	4.7%
Dividend yield	1.0%	1.1%	2.6%	2.1%	2.1%	2.4%

Key ratios	2009A	2010A	2011A	2012A	2013E	2014E
EBITDA margin	33.2%	34.6%	32.6%	31.8%	30.5%	31.3%
EBIT margin	29.7%	30.6%	29.5%	29.0%	27.8%	28.5%
Capex / Revenue	6.1%	3.0%	2.8%	2.8%	3.1%	2.8%
Capex / Depreciation	1.74	0.75	0.91	1.01	1.15	1.01
Net Debt / EBITDA	-1.3	-1.3	-1.9	-1.9	-1.9	-2.2
EBITDA / Net Interest	NA	NA	NA	NA	NA	NA
ROE	33%	27%	25.0%	24.9%	23.8%	22.3%

P&L Summary

	2009A	2010A	2011A	2012A	2013E	2014E
Revenue	216,932	227,419	275,010	337,344	394,717	429,565
% change	29.9%	4.8%	20.9%	22.7%	17.0%	8.8%
EBITDA	71,952	78,609	89,640	107,164	120,476	134,511
% change	37.3%	9.3%	14.0%	19.5%	12.4%	11.7%
% margin	33.2%	34.6%	32.6%	31.8%	30.5%	31.3%
Depreciation & Amortisation	-7,610	-9,050	-8,536	-9,220	-10,644	-11,899
EBIT	64,342	69,559	81,104	97,944	109,832	122,612
% change	38.6%	8.1%	16.6%	20.8%	12.1%	11.6%
% margin	29.7%	30.6%	29.5%	29.0%	27.8%	28.5%
Associates	0	0	0	0	0	0
Operating Profit	64,342	69,559	81,104	97,944	109,832	122,612
Interest Expenses	0	0	0	0	0	0
Other Income	4,750	9,910	12,110	19,040	19,458	21,828
Pre Tax Profit	69,092	79,469	93,214	116,984	129,289	144,440
Income Tax Expense	-9,190	-16,810	-24,900	-33,670	-36,616	-41,165
Minority Interests	0	0	0	0	0	0
Net Income	59,902	62,659	68,314	83,314	92,674	103,274
Execution Net Income	59,902	62,659	68,314	83,314	92,674	103,274
Reported EPS	104.69	109.54	119.51	145.56	162.25	180.81
EPS	104.69	109.54	119.51	145.56	162.25	180.81
DPS	23.50	25.00	60.00	47.00	48.67	54.24
Payout Ratio	22.4%	22.8%	50.2%	32.3%	30.0%	30.0%
Shares In Issue (Less Treasury)	573	571	571	571	571	571

Cash Flow Summary

	2009A	2010A	2011A	2012A	2013E	2014E
EBITDA	71,952	78,609	89,640	107,164	120,476	134,511
Taxes Paid	-9,190	-16,810	-24,900	-33,670	-36,616	-41,165
Interest Paid / Received	4,750	9,910	12,110	19,040	19,458	21,828
Change in Working Capital	-472	17,201	22,890	39,796	2,618	-8,456
Associate & Minority Dividends	0	0	0	0	0	0
Other Operating Cash Flow	-13,790	-26,870	-40,670	-50,210	-24,778	-21,828
Operating cash flow	53,250	62,040	59,070	82,120	81,158	84,891
Capital Expenditure	-13,270	-6,750	-7,780	-9,320	-12,288	-12,013
Free Cash Flow	39,980	55,290	51,290	72,800	68,870	72,878
Acquisitions & Disposals	0	0	0	0	0	0
Dividends Paid To Shareholders	-24,940	-15,740	-31,410	-20,000	-34,957	-30,993
Equity Raised / Bought Back	1,120	890	960	1,680	0	0
Other Financing Cash Flow	11,900	-29,640	24,710	-15,230	-9,632	21,828
Net Cash Flow	28,060	10,800	45,550	39,250	24,281	63,713

Balance Sheet Summary

	2009A	2010A	2011A	2012A	2013E	2014E
Cash & Equivalents	96,950	105,560	166,660	205,910	230,191	293,904
Tangible Fixed Assets	53,540	53,550	48,440	54,090	55,654	55,767
Goodwill & Intangibles	0	0	8,730	11,660	11,970	11,970
Investment in Equity Investee	0	0	0	0	0	0
Other Assets	70,770	115,930	88,800	111,820	152,966	164,203
Total Assets	221,260	275,040	312,630	383,480	450,781	525,844
Interest Bearing Debt	0	0	0	0	0	0
Other Liabilities	38,720	44,550	39,600	48,870	60,815	63,596
Total Liabilities	38,720	44,550	39,600	48,870	60,815	63,596
Shareholders' Equity	182,540	230,490	273,030	334,610	389,967	462,248
Minority Interests	0	0	0	0	0	0
Total Equity	182,540	230,490	273,030	334,610	389,967	462,248
Net Debt	-96,950	-105,560	-166,660	-205,910	-230,191	-293,904

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IMPORTANT DISCLOSURES

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Esposito Santo Investment Bank Research hereby provides the distribution of the equity research ratings in relation to the total Issuers covered and to the investment banking clients as of end of June 2012.

Explanation of Rating System

12-MONTH RATING	DEFINITION
BUY	Analyst expects at least 10% upside potential to fair value, which should be realized in the next 12 months
NEUTRAL	Analyst expects upside/downside potential of between +10% and -10% to fair value, which should be realized in the next 12 months
SELL	Analyst expects at least 10% downside potential to fair value, which should be realized in the next 12 months

TRADING RATING	DEFINITION
TRADING BUY	Analyst expects a positive short-term movement in the share price (max duration 2 months from the time Trading Buy is announced) and may move out of line with the fair value estimate during that period
TRADING SELL	Analyst expects a negative short-term movement in the share price (max duration 2 months from time Trading Sell is announced) and may move out of line with the fair value estimate during that period

Ratings Distribution

As at end June 2012	Total ESIB Research		Total Investment Banking Clients (IBC)			
	Recommendation	Count	% of Total	Count	% of IBC	% of Total
12 Month Rating:						
Buy		232	48.0%	29	67.4%	6.0%
Neutral		172	35.6%	8	18.6%	1.7%
Sell		72	14.9%	2	4.7%	0.4%
Restricted		5	1.0%	4	9.3%	0.8%
Under Review		0	0.0%	0	0.0%	0.0%
Trading Rating:						
Trading Buy		0	0.0%	0	0.0%	0.0%
Trading Sell		2	0.4%	0	0.0%	0.0%
Total recommendations		483	100%	43	100%	8.9%

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