

# UBS Investment Research

## Infosys Technologies Ltd

### Positive Catalysts Ahead: Re-iterate Buy 2

#### ■ In-line results, Robust Guidance

Infosys' results were in-line with our estimates. As expected, its FY06 revenue and earnings growth outlook of 28-30% in US\$ terms (adjusted for ESOP expensing charge) indicates robust growth environment. We see pricing increase of 1.3% onsite and 1% offshore as one of the key positives in the 4QFY05.

#### ■ Key Levers for upside in FY06

The following are catalysts in FY06: (a) Earnings upside from pricing increase is yet to be factored in, though trend has clearly begun, (b) The June quarter expectation is low and hence, easy to beat, (c) Potential Large deal closures in pipeline could enhance visibility, (d) Salary increases in FY06 at 14-15% offshore, a tad lower than in FY05 (15-17%).

#### ■ Maintain Estimates

We have factored the above in our forecasts and hence, maintain our estimates (10% above guidance). Based on above mentioned catalysts, investor expectations is quite low after results, thus lowering the valuation risk on the company. Hence, we would be buyers in a potential correction after results.

#### ■ Valuation: Re-iterate Buy 2

Our price target of Rs2600 is based on medium-term growth rate of 19%, terminal growth of 3% and WACC of 13%. This implies a FY07 P/E multiple of 21.1x based on our estimates.

Highlights (Rs m)	03/03	03/04	03/05E	03/06E	03/07E
Revenues	36,400	48,530	72,531	99,318	133,931
EBIT	10,793	13,575	20,932	28,456	37,756
Net income (UBS)	9,660	12,523	18,570	25,365	33,323
EPS (UBS, Rs)	36.51	47.33	69.44	94.86	124.61
Net DPS (UBS, Rs)	6.75	32.38	50.00	60.00	60.00

Profitability & Valuation	5-yr hist. av.	03/04	03/05E	03/06E	03/07E
EBIT margin %	32.2	28.0	28.9	28.7	28.2
ROIC (EBIT) %	85.8	127.0	269.4	232.8	211.1
EV/EBITDA x	35.2	16.9	23.1	17.0	12.5
PE (UBS) x	41.5	22.6	30.3	22.2	16.9
Net dividend yield %	0.3	3.0	2.4	2.9	2.9

Source: Company accounts, Thomson Financial, UBS estimates. UBS EPS is stated before goodwill, exceptionals and other special items. Valuations: based on an average share price that year, (E): based on a share price of Rs2,102.30 on 13 Apr 2005 21:11 HKT

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## Global Equity Research

India

Software

Rating **Buy 2**  
**Unchanged**

Price target **Rs2,600.00/US\$89.31**  
**Unchanged**

Price **Rs2,102.30/US\$68.27 (ADR)**

RIC: INFY.BO BBG: INFO IN

15 April 2005

#### Trading data (local/US\$)

52-wk. range	Rs2,264.20-1,131.76/US\$77.22-36.23
Market cap.	Rs562bn/US\$12.2bn
Shares o/s	267m (ORD)/178m (ADR)
ADR ratio	1 ADR :1 ORD
Free float	74%
Avg. daily volume ('000)	271/7
Avg. daily value (Rsm)	573.9/0.4

#### Balance sheet data 03/05E

Shareholders' equity	Rs38.2bn
P/BV (UBS)	14.7x
Net cash (debt)	Rs25.0bn

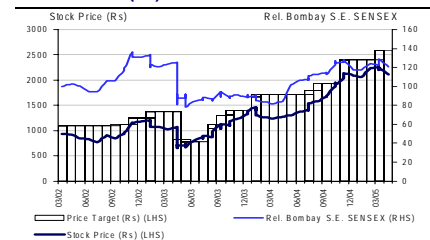
#### Forecast returns

Forecast price appreciation	+23.7%
Forecast dividend yield	2.9%
Forecast stock return	+26.6%
Market return assumption	10.7%
Forecast excess return	+15.9%

#### EPS (UBS, Rs)

	03/05E		03/04
	UBS	Cons.	Actual
Q1E	14.54	58.16	10.61
Q2E	16.34	16.71	11.45
Q3E	18.50	18.50	12.50
Q4E	19.38	-	12.76
03/05E	69.44	69.08	
03/06E	94.86	92.86	

#### Performance (Rs)



Source: UBS

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#### ANALYST CERTIFICATION AND REQUIRED DISCLOSURES BEGIN ON PAGE 6

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Infosys released its 4QFY05 earnings today. While results and its FY06 guidance were in-line with our expectations, its 1QFY06 guidance was muted. On the back of our analysis, we re-iterate Buy 2 rating on the stock.

Following are the key take-aways of our analysis:

### Results Versus Estimates

Infosys reported revenues of Rs19873.2mn, up 6% q-o-q, EBITDA margins improved by 60 bps, while pre-exceptional net profits grew to Rs5135 mn, up 3.2% q-o-q. There was exceptional other income of Rs 452 m due to sale of Yantra. Its results were in line with our estimates.

- Revenue growth comprised of onsite pricing increase of 1.3% q-o-q and offshore pricing increase of 0.9% q-o-q and volume increase of 7% q-o-q.
- Infosys had net employee adds of 1521 and gross client adds of 37. We note that its client adds were amongst the highest over the past few quarters.
- Progeon added 544 people in the quarter and now has 3966 people.
- Capacity Utilisation (including trainees) increased to 73.2% from 71.4% a quarter ago. However capacity utilization (excluding trainees) was down at 76.6% from 79.3% in 3QFY05.
- Receivables were at 61 days. Cash balances stood at Rs 15.75 billion.

### FY06 Guidance highlights robust demand environment

Infosys guided for revenue and earnings growth of 28-30% in US\$terms in FY06. The following table highlights the same:

Table 1: Comparisons of Management Outlook

	FY2005		FY2006	
	Indian GAAP	US GAAP	Indian GAAP	US GAAP
<b>Guidance</b>				
Revenues	Rs59,940-60,410m	\$1,381-1,392m	Rs88,900-90,290m	\$2,038-2,070m
Revenue growth	24%	30%	25-27%	28-30%
EPS*	Rs56	\$0.66	Rs84.6-85.9	\$2.00-2.04
EPS growth*	20%	27%	23-25%	28-30%

Source: Company Data, Adjusted back US GAAP for ESOP expensing charge to reflect organic earnings growth

We believe, despite growing by almost 50% in FY05, its growth guidance remains the same as FY05, thus indicating strength of offshore demand in FY06.

### Muted 1QFY06 outlook could be conservative

The following factors make us believe that 1QFY06 guidance is conservative:

- **Financial Services customers have sluggish ramp-ups in March quarter.**  
Based on analysis of historic trends, we believe, financial services customers

typically ramp-up from “June quarter” onwards, while the “March quarter” is typically muted.

For example, Amex and Aetna, two of Infosys’ top clients declined by 40% q-o-q and 13% q-o-q respectively in March quarter FY04, but scaled up significantly in subsequent quarters.

The weakness within Financial Services vertical in this quarter (up 1.7% q-o-q) could be partly attributed to this. Hence, ramp-ups in June quarter could be stronger than expected.

■ **Reasons behind muted 1QFY06 guidance.** Management pointed towards two key reasons for sluggish June quarter:

- **Re-organisation within three-to-four top clients.** We see this as a routine phenomenon but in most other cases have witnessed growth coming back after two quarters, like Transco in the case of Wipro.
- **Regulatory compliance by clients.** While Infosys mentioned sluggish ramp-ups in June quarter due to diversion of attention of client’s senior management team towards internal regulatory compliance rather than external outsourcing plans, we believe, the June quarter deadline is applicable for smaller companies.

Amongst the two reasons mentioned by the company, re-organisation could be a bigger reason than regulatory compliance in our opinion.

Also, both these issues are short-term phenomenon and doesn’t indicate any potential slowdown in demand scenario.

## Key Levers for upside in FY06

Based on our analysis, we see the following upsides to consensus estimates during FY06:

■ **Pricing increase not yet factored in.** We continue to believe, Infosys will likely witness average pricing increase of 2% y-o-y in FY06. This is clearly not factored in current consensus estimates. The following table indicates that average pricing is gradually increasing over past few quarters.

**Table 2: Pricing movements y-o-y**

	Q1 FY04	Q2 FY04	Q3 FY04	Q4 FY04	Q1 FY05	Q2 FY05	Q3 FY05	Q4 FY05
Onsite	-0.8%	-4.7%	-5.1%	-0.6%	-0.5%	-0.3%	-0.2%	1.5%
Offshore	-6.2%	-3.2%	-3.7%	1.9%	2.3%	0.7%	0.7%	1.7%

Source: Company Data

As indicated in the table above, the trend is clearly towards increase in average pricing in FY06. Notably, management indicated that they have witnessed sporadic price increases of 3-4% amongst existing customers and consistent pricing increases of 3-4% amongst new customers.

- **Conservative June quarter guidance.** With extremely low expectations of June quarter, we believe, even a revenue growth of 5-6% q-o-q (higher than guidance of 0.7-1.6%) could trigger significant upside (6-7%) to revenue and earnings growth in FY06.
- **Large deal closures.** We believe, Infosys is in the final short-list of larger contracts like that of ABN AMRO, which could increase visibility significantly in medium-term.
- **Salary increase lower in FY06.** We believe, Infosys is better positioned to manage its financials in FY06 as its offshore salary increase of 14-15% is lower than in FY05 (15-17%). This will result in better EBITDA margin outlook for the company in coming quarters.

Based on our analysis of above factors, we maintain our estimates of 35% earnings growth in FY06, about 10% higher than management's outlook.

### Rationale for price target

We have not revised our earnings estimates on the back of results. Our price target of Rs2600 is based on medium-term growth rate of 19%, terminal growth of 3% and WACC of 13%. This implies a FY07 P/E multiple of 21.1x based on our estimates.

Our predictability rating of 2 indicates higher volatility of earnings.

### Outlook and Valuations

We clearly see any dip in share-prices post-results due to muted 1QFY06 guidance as a potential strong buying opportunity. We believe, management has sufficiently lowered investor expectations on the back of these results. We continue to rely on our channel checks, to conclude that FY06 demand scenario continues to be robust. Maintain Buy2.

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■ **Infosys Technologies Ltd**

Infosys is the second largest IT services company (in terms of revenues) in India with an employee base of approximately 28,000. Its service offerings include application development, maintenance and re-engineering, package implementation and consulting, which it provides to overseas clients through various offshore development facilities in India. It derives 65% of its revenue from the US, 22% from Europe, and the remainder from Asia Pacific. Its IT-enabled services company, Progeon, provides BPO services. Key verticals serviced are banking, finance, insurance and manufacturing.

■ **Statement of Risk**

A sharp downtick in IT Services spending could result in downside to our earnings estimates.

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UBS rating	Definition	UBS rating	Definition	Rating category	Coverage <sup>1</sup>	IB services <sup>2</sup>
<b>Buy 1</b>	FSR is > 10% above the MRA, higher degree of predictability	<b>Buy 2</b>	FSR is > 10% above the MRA, lower degree of predictability	<b>Buy</b>	37%	30%
<b>Neutral 1</b>	FSR is between -10% and 10% of the MRA, higher degree of predictability	<b>Neutral 2</b>	FSR is between -10% and 10% of the MRA, lower degree of predictability	<b>Hold/Neutral</b>	52%	32%
<b>Reduce 1</b>	FSR is > 10% below the MRA, higher degree of predictability	<b>Reduce 2</b>	FSR is > 10% below the MRA, lower degree of predictability	<b>Sell</b>	11%	25%

1: Percentage of companies under coverage globally within this rating category.

2: Percentage of companies within this rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS; as of 31 March 2005.

### KEY DEFINITIONS

**Forecast Stock Return (FSR)** is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

**Market Return Assumption (MRA)** is defined as the one-year local market interest rate plus 5% (an approximation of the equity risk premium).

**Predictability Level** The predictability level indicates an analyst's conviction in the FSR. A predictability level of '1' means that the analyst's estimate of FSR is in the middle of a narrower, or smaller, range of possibilities. A predictability level of '2' means that the analyst's estimate of FSR is in the middle of a broader, or larger, range of possibilities.

**Under Review (UR)** Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.

**Rating/Return Divergence (RRD)** This qualifier is automatically appended to the rating when stock price movement has caused the prevailing rating to differ from that which would be assigned according to the rating system and will be removed when there is no longer a divergence, either through market movement or analyst intervention.

### EXCEPTIONS AND SPECIAL CASES

**US Closed-End Fund ratings and definitions are:** Buy: Higher stability of principal and higher stability of dividends; Neutral: Potential loss of principal, stability of dividend; Reduce: High potential for loss of principal and dividend risk.

**UK and European Investment Fund ratings and definitions are:** Buy: Positive on factors such as structure, management, performance record, discount; Neutral: Neutral on factors such as structure, management, performance record, discount; Reduce: Negative on factors such as structure, management, performance record, discount.

**Core Banding Exceptions (CBE):** Exceptions to the standard +/- 10% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Companies Mentioned table in the relevant research piece.

### Companies mentioned

Company Name	Reuters	Rating	Price	Price date/time
<b>ABN AMRO</b> <sup>2,4b,16</sup>	AAH.AS	Buy 2	€19.50	13 Apr 2005 21:28 BST
<b>Infosys Technologies</b> <sup>2,4a,5,8,13,16</sup>	INFY.BO	Buy 2	Rs2,102.30	13 Apr 2005 21:11 HKT

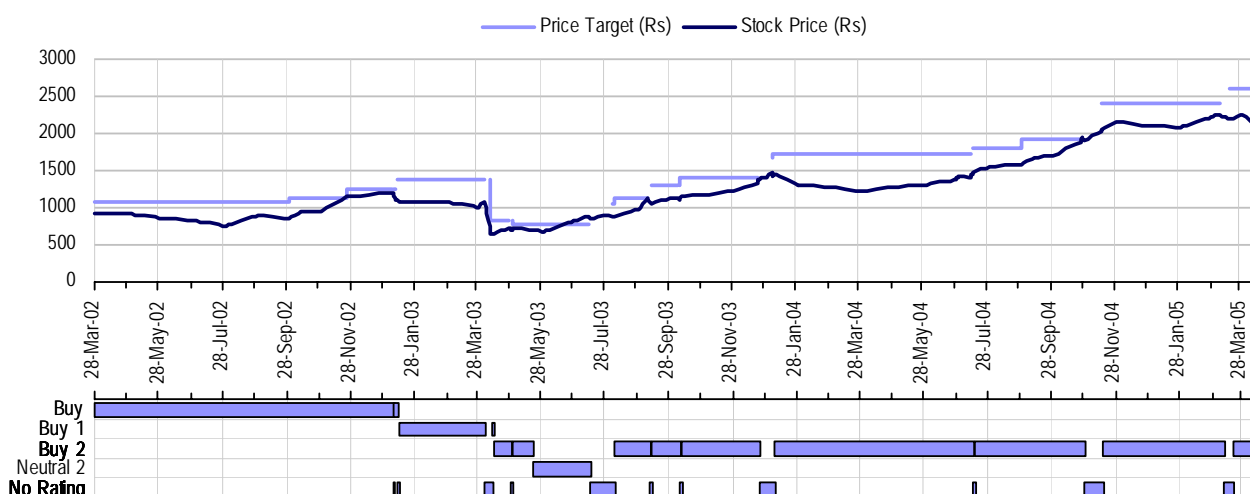
Company Name	Reuters	Rating	Price	Price date/time
National Grid Trans. <sup>4b,16</sup>	NGT.L	Neutral 1	506p	13 Apr 2005 21:28 BST
Wipro Ltd <sup>16</sup>	WIPR.BO	Neutral 2	Rs645.95	13 Apr 2005 21:11 HKT

Source: UBS. BST: British summer time; HKT: Hong Kong time.

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### Infosys Technologies Ltd (Rs)



Source: UBS; as of 13 April 2005.

Note: On October 13, 2003, UBS adopted new definition criteria for its rating system. (See 'UBS Investment Research: Global Equity Ratings Definitions and Allocations' table for details.) Between January 11 and October 12, 2003, the UBS ratings and their definitions were: Buy 1: Excess return potential > 15%, smaller range around price target; Buy 2: Excess return potential > 15%, larger range around price target; Neutral 1: Excess return potential between -15% and 15%, smaller range around price target; Neutral 2: Excess return potential between -15% and 15%, larger range around price target; Reduce 1: Excess return potential < -15%, smaller range around price target; Reduce 2: Excess return potential < -15%, larger range around price target. Prior to January 11, 2003, the UBS ratings and definitions were: Strong Buy: Greater than 20% excess return potential, high degree of confidence; Buy: Positive excess return potential; Hold: Low excess return potential, low degree of confidence; Reduce: Negative excess return potential; Sell: Greater than 20% negative excess return potential, high degree of confidence. Under both ratings systems, excess return is defined as the difference between the FSR and the one-year local market interest rate.

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