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Infosys Technologies, Ltd. INFY

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by Mike Ford-Taggart, CFA

Analyst Note 10-10-2008

Infosys Technologies INFY reported fiscal second-quarter results that were in line with our expectations. However, due to management's cautious comments regarding the client spending environment going forward, we are lowering our fair value estimate. Our previous estimate had foreseen a slowdown, but we now believe that with two-thirds of revenue coming from financial services, manufacturing, and retail firms that an even more cautious stance is prudent. Year-over-year revenue for the first half of fiscal 2009 increased 22%, to $2.4 billion, but the firm did report weak 2% sequential growth in its largest segment--financial services--reflecting weakness in that end market. The firm continued adding new clients to its roster, gaining 40 clients during the quarter. Comments from several IT services firms' management teams make clear that existing clients are scaling back on discretionary projects, an important source of growth. Infosys' management still expects revenue growth of 13%-15% in fiscal 2009, with most of it already having been reported.

Despite the challenging sales environment, the firm held costs in check. Management continues to pull various operating levers, such as wage increases and employee utilization, to maintain margins. Operating margins improved 2 full percentage points year over year, to 28.3%.

Infosys remains a class act in the IT services industry, with more than 90% of its revenue coming from clients who have been with the firm for longer than 12 months. Although revenue growth may slow in the near term, management has shown a repeated capability of protecting profitability and managing cash resources--the two things that matter most to long-term investors. With $1.9 billion in cash on the balance sheet and no debt, we believe Infosys is well positioned to emerge on the other side of the global macroeconomic downturn relatively unscathed.

Thesis 10-10-2008

Infosys Technologies has been honing its human resource capabilities and its marketing skills for more than 15 years, becoming the largest Indian-based information technology services company that we cover. With a cost structure that is leaner than rivals' and quality deliverables that command a price premium, Infosys is well-positioned to continue its remarkable and profitable growth for years to come, in our opinion.

Attracting top college recruits, Infosys has shown a sustained ability to deliver projects at what might be the lowest cost in the entire IT services industry. Infosys hires new recruits at will: Only 1.5% of applicants eventually get hired, and 5% of new hires do not graduate from mandatory training. The firm recently built a training campus in Mysore

Morningstar Rating
★★★★★

Stock Price
As of 10-10-2008
$23.91

Fair Value Estimate
$35.00

Consider Buying
$24.50

Consider Selling
$49.00

Fair Value Uncertainty
Medium

Economic Moat
Narrow

Stewardship Grade
B

Bulls Say

- Infosys was added to the Nasdaq 100 Index in December 2006--the first Indian member--after Infosys directors, executive officers, and a large shareholder sold 30 million ADSs in November 2006 to increase the number of ADSs available to trade.
- On a market share basis, Infosys has plenty of room to expand. On the basis of market size studies, we believe Infosys captures 1.5% of global outsourcing spending and about 12.5% of revenue from offshore deals sent to India. Management estimates it captures about 10% of its largest clients' IT spending.
- Consulting will bring long-term benefits to Infosys, as it can drive downstream IT work. This will be primarily a future contribution, as the unit is not yet profitable.

Bears Say

- Wage inflation brought on by increased demand for IT professionals--primarily because of the entry of multinational companies--puts a significant that is the largest corporate training facility in the world. Whether because of Infosys' work amenities (the main campus in Bangalore looks like a high-end college campus, complete with a three-hole golf course) or the training employees receive, attrition levels are near the industry's lows. By hiring a significant amount of relatively lower-paid new recruits every year and holding attrition down, Infosys is able to manage labor costs aggressively. According to our calculations, the average cost per Infosys employee is about $34,000 per year, compared with $35,000 at offshore rival Wipro WIT and $110,000 at Accenture ACN. Management is adamant that legacy firms like Accenture will never be able to match its cost structure--regardless of 15% annual wage growth for Indian employees--and we believe it.

Management also made a decision in the early 1990s that having a low profile was a disadvantage in the marketplace. To raise its profile, the firm racked up an impressive list of firsts: the first Indian firm to offer employee stock options, to file a U.S. annual report, to use U.S. accounting standards, and to become a member of the Nasdaq 100 index. While some may argue that this is sheer marketing blitz, we believe it has demonstrably affected the company's fundamentals. Infosys tends to work on larger deals ($6.5 million compared with $4.8 million at Wipro) and brings in about 10% more revenue per employee, according to our calculations, than Indian-based rival Wipro, a very strong firm in its own right. Over the past two years, our analysis suggests that Infosys has been winning significantly larger deals.

We believe Infosys' amazing performance since inception will continue and that the firm will come to be seen as a global company that simply happens to be based in India.

Valuation

We are lowering our fair value estimate to $35 per ADR from $43, having further moderated our revenue growth and operating margin assumptions for the next few years. Given the slowdown in growth expected in fiscal 2009 and our belief that this will persist into fiscal 2010, our five-year average annual revenue growth expectation is now 13% (versus 16% previously). Infosys increased revenue 35.1% last year. To be sure, 13% is still impressive, especially given the market's trepidations regarding global IT spending over the next two years. We believe such growth will come about for three reasons. First, Infosys' disruptive low-cost, high-benefit positioning has allowed it to accelerate revenue growth and land significantly larger deals--on average--over the past two years. Second, with a stronger product lineup, Infosys is penetrating accounts in Europe much faster than it initially did in the United States. Third, this growth is being driven by continued strong demand for offshore services and additional service offerings. About 93% of revenue is recurring (from clients who were with the firm for more than 12 months). Over the past 10 years, gross margins have come under considerable pressure, and we expect that to continue, albeit at a more moderate rate of decline. We also now believe, due to lengthening sales cycles, that leveraging selling, general, and administrative costs will prove difficult over the next two years. We expect operating margins to decline slightly over the next five years, falling from 27.6% in fiscal 2008 to about 26% in fiscal 2013. Infosys' management maintained steady margins between 2007 and 2008, despite the significant pressures applied by the volatile Indian rupee; we are confident it can continue to protect the operating margins. We peg the firm's cost of equity at 10.5%. Our assumptions yield returns on invested capital well above 40%.

Risk

strain on operating margins. Salaries have been increasing about 15% per year.

- Foreign currency fluctuations can wreak havoc with operating results. Infosys uses financial instruments to hedge this risk, but a strengthening rupee can still hurt operating margins.
- As with other emerging economies, India is subject to sudden economic and political upheavals. This heightens the volatility of Infosys' shares, which trade on the Indian stock exchanges.

Infosys' growth, in and of itself, constitutes the uncertainty around our fair value estimate. Although we have no concerns about Infosys' ability to attract top talent, the training of new recruits and lateral hires can strain the system. Already the corporate training center in Mysore is being extended. With such high revenue growth, Infosys is under increased pressure to retain, recruit, and train resources to work on projects. Any misstep could hinder growth and hurt margins.

Close Competitors	TTM Sales $Mil	Market Cap $Mil
Infosys Technologies, Ltd.	**4,176**	**13,658**
Tata Consulting	NA	NA
* Accenture, Ltd.	24,326	21,344
* EDS	22,449	12,611
* International Business Machines Corp	104,307	118,887
* Satyam Computer Services, Ltd.	2,138	5,371
* Wipro, Ltd.	4,851	9,689

* Morningstar Analyst Report Available

Data as of 05-31-08

Strategy

Infosys' strategy is to deliver faster, better, and cheaper services to its clients by leveraging its people, technology, and processes. To position itself for the future, Infosys has expanded its geographic footprint and its services lineup in the last few years. Of 40 global delivery centers, 20 of them are outside India. Consulting and transformative IT services have been added to provide clients with offerings across the IT value pyramid. The firm remains a disruptive force in the industry.

Management & Stewardship

Cochairman and chief mentor Narayana Murthy stepped down from active involvement with the firm in August 2006, when he reached the firm's mandatory retirement age of 60. Murthy was one of the firm's founders and built a reputation of fostering strong corporate governance, in addition to being credited with Infosys' amazing rise as a global IT titan. He owns about 5% of the firm's outstanding stock. Nandan Nilekani, another founder and the second pillar of Infosys' success, stepped down as CEO in June 2007 after 10 months in the role. He became the other cochairman and owns almost 20 million shares. CEO S. Gopalakrishnan had jointly run the firm since 1981 with Murthy and Nilekani and became CEO after Nilekani. Gopalakrishnan owns more than 19 million shares. Infosys has long served as a model for Indian corporate transparency and became the first among its peers to grant employee stock options. Infosys was the first Indian company to list its shares on the Nasdaq exchange and is one of the first foreign firms to meet U.S. Sarbanes-Oxley requirements. There are no material related-party transactions. The company's reputation for integrity is underscored by numerous stories of executives refusing to pay bribes to officials in the firm's younger years.

Profile

Founded in 1981 by seven software engineers with the equivalent of $250, Infosys Technologies is the poster child of the New India and one of the world's largest IT services firms. The Bangalore-based firm offers a full range of IT services, from application maintenance to management consulting. Although it's known best for offshore work, more than 50% of revenue comes from on-site and near-shore assignments.

Growth

Infosys posted average annual revenue growth of 41% and operating income growth of 37% from 2003 to 2008. We expect annual revenue growth to decelerate during the next five years, slowing to 11% in 2013.

Profitability

To say that Infosys is highly profitable understates the point. Historical operating margins in the mid-30s have come down to the high 20s because of fluctuating billing rates and cost pressures.

Financial Health

The balance sheet is superb, with about $1.9 billion in cash and equivalents and no debt. Infosys carries a better credit rating than India's sovereign credit rating, an unusual event.

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