

Infosys

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Market Performer

Rs4436 P/E (FY03E) - 31x

Topline spikes 9%; bottom-line up 11%

IT heavyweight Infosys has recorded a 9% surge (sequential) in topline as against our expectation of 4% during Q3FY03. However, the volume increase has come at the expense of margins. Net profit numbers (Rs2520mn) are very close to our estimate. The next quarter guidance has been revised slightly upwards by the company, which we believe the company can comfortably achieve.

Gross Margin slides from 46.8% (Q2FY03) to 44.9% (Q3FY03)

- Onsite contribution to revenue has increased from 54.6% in Q2FY03 to 55.5% in Q3FY03.
- Infosys subcontracts Onsite work (currently around 100 employees). According to the company its expenditure on such subcontracting has increased in Q3FY03.
- Massive recruitment undertaken in Q2 FY03; utilisation declined; software professionals on Bench and in Training increased.
- The company made some software purchases in anticipation of future requirements (these software purchases are written-off as revenue expenditure and are not capitalised).

Operating Margin declines from 30.6% (Q2FY03) to 28.7% (Q3FY03)

Even as selling and marketing expenses were up just marginally, general and administration expenses shot up by almost 17% on the back of setting up a support structure to manage the 2,850 New Infosysians who joined in Q2 and Q3 of FY03.

**The company earned Net Profits of around Rs2,520mn this quarter (Net Margins of around 26.1%)
The non-operating items affecting the Net Profits are as follows ...**

Other Income increased by around Rs306mn sequentially

The other income reported by the company in Q3FY03 is significantly higher than Q2FY03. As mentioned by us in our Q2FY03 result analysis, as the Indian Rupee stopped depreciating against the US Dollar, Infosys had to bear a significant loss on this account. In our estimates for the company, we had expected a mild loss in Foreign exchange positions. **The company has improved its Foreign Exchange account position significantly. From a net loss of around Rs165mn to a profit of around Rs123mn (a net improvement of over Rs287mn)!** It is very difficult to predict Foreign Exchange Gains/Losses for an IT company. Hence, for our estimates for Q4 and full-year FY03 we assume a neutral position on the Foreign Exchange account.

Other Income Breakdown*	Rs Million		
	Q2FY03	Q3FY03	Change
Exchange Gain / (Loss)			
Booked	(16)	88	104
Open Positions – Marked to Market	(149)	35	183
Interest Income	181	192	11
Others	10	17	7
Total	26	332	306

Taxes as a % of PBT up 18.6%

Taxes as a % of PBT stood at around 18.6% in Q3FY03 (16.6% in Q2FY03) mainly due to higher Onsite Revenues and higher Other Income.

How do our estimates compare ...

Karvy pre-results Net Profit estimates for Infosys were the lowest at around Rs2,464. In the Reuters conducted Poll on Infosys, the consensus estimates stood at around Rs2,671. Infosys results were significantly below market expectations. However, they were pretty close to our own estimates. Minus the excess other income of Rs306mn that Infosys garnered in Q3FY03 (and the tax Infosys must have paid on that income), we arrive at a Net Profit figure of around Rs2,332mn, which is 5% lower than our own

estimate, and around 13% below market estimates. We reiterate that it is very difficult to predict Forex Gains/Losses for an IT company. Hence, for our estimates for Q4 and full-year FY03 we assume a neutral position on the Foreign Exchange account.

Rs Million			
Infosys Net Profit	Q3 FY03	Variance from Karvy Estimates	Variance from Concensus Est
Karvy Estimates	2,464		
Reuters Poll Consensus Estimates	2,671		
Reported Profits*	2,520	2%	-6%
Less: Excess 'Other Income' over Q2	306		
Less: Tax on the Excess 'Other Income'	(118)		
Reported Profits (Adjusted)*	2,332	-5%	-13%

* US GAAP Consolidated Results (US Dollar numbers converted to Indian Rupees)

Other Key Highlights

- Revenues from Retail, Banking, Financial Services and Manufacturing verticals increased, while Telecom saw a marginal decline
- Development, Maintenance and Package Implementation work contributed incremental revenues
- Utilisation dropped to 76% following the 2850 strong recruitment carried out in Q2 and Q3 FY03.
- Attrition was down significantly from 8.5% (Q2FY03) to around 5% in Q3FY03
- Onsite and Offshore Billing rates were stable
- Added 23 new clients including
 - Bristol-Myers Squibb
 - Compass Bank
 - Swiss Re Insurance
 - A&T Wireless
 - TTPCom (as a partner)

View and Valuation

We expect the aggressive ramp-up seen in Infosys to start reflecting in its financials in the ensuing 2-3 quarters. However, as the current quarter's operating numbers clearly indicate, the new business being acquired by Infosys comes at a certain cost. Unlike in the past, Infosys would be looking at bagging mega deals/projects for which the expenditure on infrastructure and sales and marketing would be high resulting in pressure on margins. Thus, the margin stabilisation/improvements are not as immediate as everyone expected. Our revenue and profit estimates had taken into account these factors, and which is why our estimates were very close to actuals.

The stock is up around 22% from our Out Performer call on 11 Oct 2002 (even after the Rs360 fall the stock witnessed following announcement of the Q3 results!) During the quarter, the stock touched a high of Rs4,883 ... clearly a case where market expectations were running ahead of company fundamentals. **We reduce our rating on the stock to Market Performer. We feel that there is a limited short-term upside in the stock from current levels.**

Projections

Yearly Projections

Rs Million

Year Ended March 31	2002	2003 Karvy Estimates	Change %
Revenues	25,993	36,236	39%
Net Profits	7,843	9,551	22%
EPS (Rs)	118.7	143.3	21%
P/E (x)	37	31	

Note: US GAAP Consolidated Results (US \$ numbers converted to Indian Rs)

Quarterly Projections

Rs Million

Year Ended March 31	Q4 2003E	Q4 2003E	Q4 2003E
	<i>Karvy Estimates</i>	QoQ % Growth	YoY% Growth
Revenues	10,129	5%	49%
Net Profits	2,666	6%	30%
EPS (Rs.)	39.98	6%	29%

Note: US GAAP Consolidated Results (US Dollar numbers converted to Indian Rs)

Consolidated Results

US GAAP Consolidated Results

Rs Million

Year Ended March 31	Q32002	Q22002	QoQ %Chg	Q32002	YoY %Chg
Revenue	9,647	8,813	9.5%	6,598	46.2%
Cost of revenues	5,315	4,690	13.3%	3,504	51.7%
Gross profit	4,331	4,123	5.1%	3,095	40.0%
Operating Expenses					
Selling, general and administrative expenses	1,463	1,340	9.2%	838	74.7%
Selling and Marketing	721	704	2.5%	328	119.8%
General and Admin	742	636	16.6%	509	45.6%
Amortization	105	90	15.8%	59	76.6%
Total operating expenses	1,567	1,430	9.6%	897	74.8%
Operating income	2,764	2,693	2.6%	2,198	25.7%
Other income, net	332	26	1177.5%	149	122.5%
Income before income taxes	3,095	2,719	13.9%	2,347	31.9%
Provision for income taxes	575	450	27.7%	350	64.6%
Net income	2,520	2,268	11.1%	1,997	26.2%
No. of Shares (Diluted)	66.7	66.2	0.7%	66.1	0.8%
EPS (Rs)	37.80	34.28	10.3%	30.22	25.1%
Gross Margins	44.9%	46.8%		46.9%	
OPM	28.7%	30.6%		33.3%	
PBT Margins	32.1%	30.8%		35.6%	
NPM	26.1%	25.7%		30.3%	
Tax/PBT	18.6%	16.6%		14.9%	
Other Income/PBT	10.7%	1.0%		6.3%	

Note: US \$ numbers converted to Indian Rs

Stock Ratings Absolute Returns

Buy	:	> 25%
Out Performer	:	16 - 25%
Market Performer	:	0 - 15%
Under Performer	:	< 0%

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