PRATIBHUTI

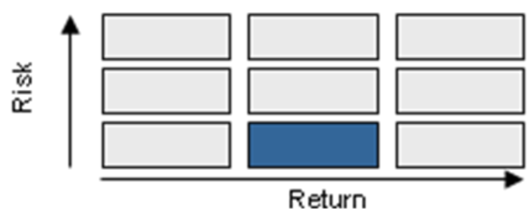
December 31, 2013

Infosys Limited.

CMP(31/12/2013)	Intrinsic Value Range(31/12/2013)	Recommendation
INR 3,482.6	INR 3,254-3,579	HOLD

- INFY's return on invested capital (ROIC) has declined over the past decade, primarily due to consistent decline in gross margins from 48.4% in FY04 to 39.3% at the end of 2Q14. Gross margins have declined in the past two quarters as company gave wage hikes to its employees.
- Gross margins have additionally been pressured as declining revenue growth rates in the last two and half years (less than 16% YoY growth rate) have not kept up with investments in its employee costs. Prime factor contributing to deteriorating revenue growth is reduction in application development and maintenance (ADM) revenue pie from 55.8% in FY04 to 35.1% in 2Q14. In past five years INFY's ADM revenues have grown at dismal single digit YoY growth rates. On the other hand, TCS has been able to grow its ADM revenues at rates around 20% YoY.
- However, INFY still has good fundamentals that justify its premium stock price. INFY has consistently good FCFs over the past decade and generated FCF at 20.7% of its operating assets in the latest quarter. INFY still earns ROIC of 40% on the back of 40% gross margin and operating margin above 20%, justifying premium P/E associated with INFY stock price. We believe that INFY will continue to earn ROIC above 35% in the near term due to improving demand environment in US.
- Given INFY's solid operating fundamentals, we advocate long term Price/ (Average three years earnings) range of 20-22, in spite of some of the issues discussed earlier. Our FY14 P/E estimate assumes USD revenue growth rate of 11.1% and INR earnings growth rate of 7.8% for FY14. Price/ (Average three years earnings) range of 20-22 gives us price range of INR3,254-3,579 leading to a "HOLD" recommendation.

Risk Return Matrix

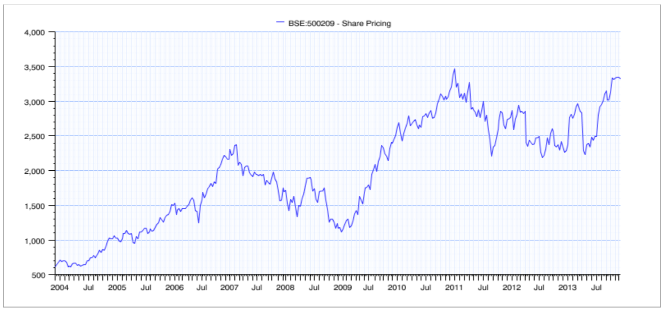


EPS - FY11	EPS - FY12	EPS - FY13	EPS - FY14E
INR 119.4	INR 145.5	INR 164.9	INR 177.7

Market Profile

BSE	NSE	BLOOMBERG	REUTERS
500209	INFY	INFO:IN	INFY.NS

52 week price range	INR 2,186-3,448
Average 3 month daily volume(mn)	0.1
Beta	0.83
Dividend yield	1.6%
Shares outstanding (mn)	571.4
Market cap (INR mn)	19,00,828
Float	83.4%
% Institutional Holdings	54.2%
% Public and Others	29.6%
Borrowings/ Assets	0.0%
Return on equity	24.5%
Return on assets	14.4%

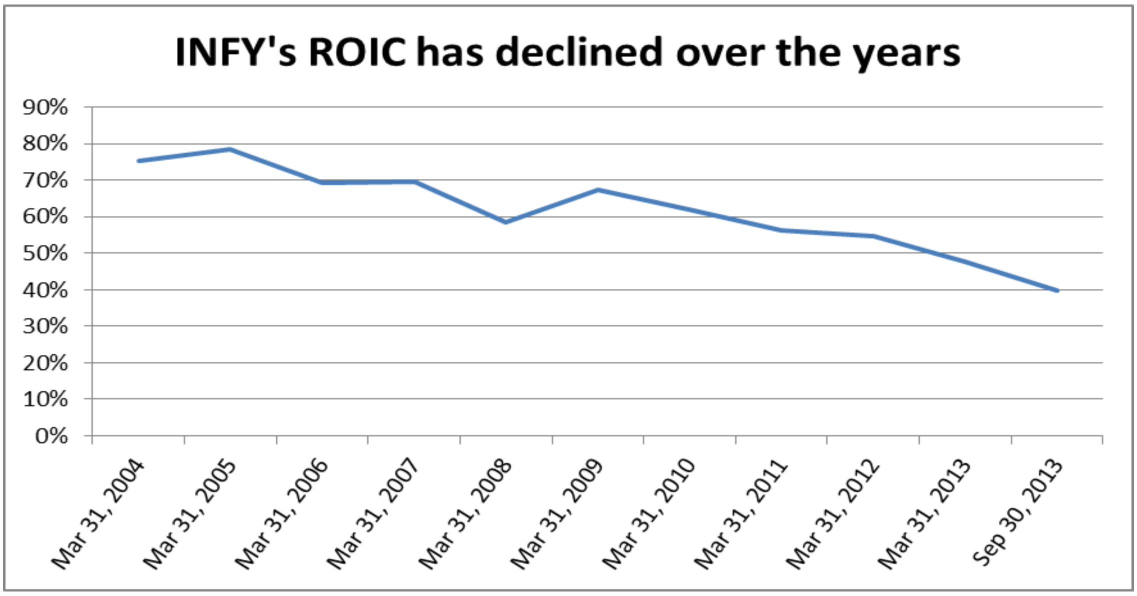


Decline in ROIC caused by increase in employee costs and deteriorating revenue growth rates

INFY's return on invested capital (ROIC) has declined over the years, primarily due to consistent decline in gross margins from 48.4% in FY04 to 39.3% at the end of 2Q14

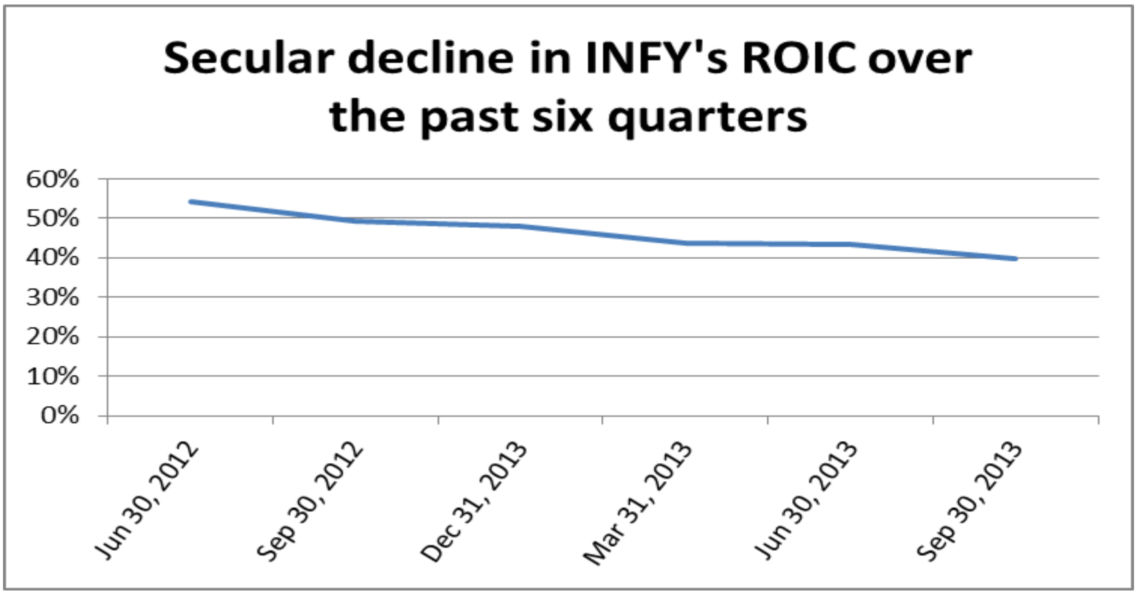
INFY's return on invested capital (ROIC) has declined over the years, primarily due to consistent decline in gross margins from 48.4% in FY04 to 39.3% at the end of 2Q14 (Figure 1 and Figure 2). Gross margins have declined (Figure 3) due to secular increase in employee benefit costs (Figure 4). In the latest quarter, INFY's gross margin has declined to 39.3% as the company gave wage hikes to its employees.

Figure 1: Decline in INFY's ROIC over the years has caused concern among investors



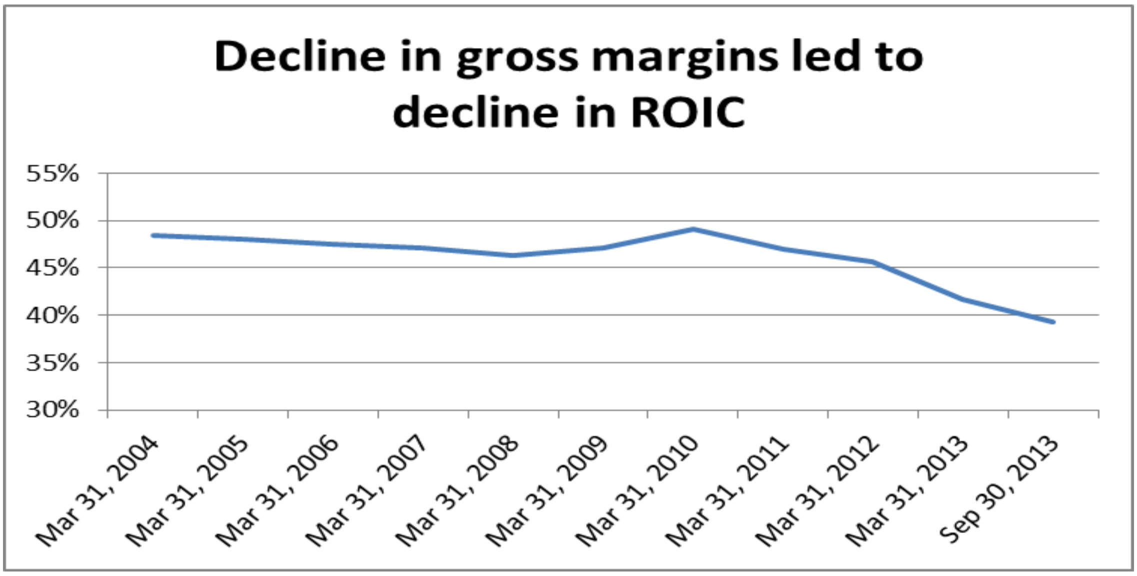
Source: Company documents

Figure 2: Secular decline in INFY's ROIC over the past six quarters



Source: Company documents

Figure 3: Gross margins have been under pressure recently due to increasing employee costs



Source: Company documents

Figure 4: Increasing Employee costs (as % of revenue) have contributed to decline in gross margins

Source: Company documents

Gross margins have been pressured by declining revenue growth rates and increasing employee costs

Gross margins have additionally been pressured as declining revenue growth rates (Figure 5) in the last four years have not kept up with investments in its employee costs (Figure 4 above). Given that INFY has already given wage hikes in the first two quarters, we expect operating margin to improve to 23.7% in FY14 compared to 21.9% at end of 2Q14 assuming USD revenue growth of 11.1% in FY14 (against company guidance of 9-10%). However, we emphasize that revenue growth is the single most important valuation driver in future quarterly earnings releases as higher revenues will be required to compensate for fixed investments in employee salaries.

Figure 5: Revenue growth (YoY) of less than 20% in the last four years has pressured gross margins

YoY	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	1Q14	2Q14
Revenue (USD mn) growth rate	41.0%	49.8%	35.2%	43.6%	35.1%	11.7%	3.0%	25.7%	15.8%	5.8%	13.6%	15.0%

Note: YoY 1Q14 and 2Q14 growth rates do not exclude impact of Lodestone acquisition

Source: Company documents

Deterioration in application development and maintenance revenue growth rate has impacted cumulative revenue growth rate

TCS has been able to grow at higher rates compared to those of INFY

We note that TCS has been able to grow at higher rates compared to those of INFY (Figure 6) in the past four and half years in spite of TCS recording free cash flow (INR8,927cr in FY13) that is twice as that of INFY's (INR4,470cr in FY13). It is no coincidence that investors has found INFY guilty of not utilizing its cash (INR22,543cr at 2Q14 end) to make acquisitions or to increase its dividend payout ratio.

Figure 6: TCS's revenue growth has outpaced INFY's in last four and half years

YoY revenue growth rates	2009	2010	2011	2012	2013	1Q14	2Q14
Infosys	11.7%	3.0%	25.7%	15.8%	5.8%	13.6%	15.0%
TCS	6.8%	5.4%	28.9%	24.5%	13.7%	16.0%	17.0%

Source: Company documents

Given the concerns over INFY's revenues, we next inspect its revenues by service lines.

Figure 7: Application development and maintenance (ADM) revenue pie has declined

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2Q14
Business IT Services	**73.0%**	**72.0%**	**71.8%**	**72.9%**	**69.8%**	**67.6%**	**67.2%**	**62.8%**	**63.0%**	**62.9%**	**61.4%**
Application Development	25.7%	23.2%	20.2%	21.0%	21.7%	20.5%	18.0%	16.0%	16.8%	16.3%	16.0%
Application Maintenance	30.1%	29.9%	30.2%	29.3%	23.7%	21.9%	23.3%	22.9%	21.6%	20.5%	19.1%
Infrastructure Management Services					4.9%	6.3%	7.2%	6.3%	6.0%	6.9%	7.2%
Testing Services	5.3%	5.8%	5.9%	6.9%	7.5%	6.8%	6.4%	7.5%	7.9%	8.4%	8.4%
Product Engineering Services	2.2%	2.0%	1.8%	1.6%	1.6%	2.2%	2.2%	2.4%	3.4%	3.3%	3.3%
Business Process Management	1.6%	2.7%	4.0%	4.7%	5.7%	6.0%	6.1%	4.9%	4.6%	5.0%	5.1%
Others	8.1%	8.4%	9.7%	9.4%	4.7%	3.9%	4.0%	2.8%	2.7%	2.5%	2.3%
Consulting, Package Implementation & Others	**24.2%**	**25.0%**	**24.4%**	**23.2%**	**26.6%**	**28.5%**	**28.6%**	**31.2%**	**31.2%**	**31.4%**	**33.3%**
System integration	6.0%	6.2%	4.7%	2.1%	2.8%	3.6%	4.2%				
Package implementation	14.5%	15.2%	16.2%	17.5%							
Consulting	3.7%	3.6%	3.5%	3.6%							
Products, Platforms and Solutions	**2.8%**	**3.0%**	**3.8%**	**3.9%**	**3.6%**	**3.9%**	**4.2%**	**6.0%**	**5.8%**	**5.7%**	**5.3%**
Products	2.8%	3.0%	3.8%	3.9%	3.6%	3.9%	4.2%	4.9%	4.6%	4.0%	3.7%
BPM Platform								0.7%	0.9%	1.3%	1.2%
Others								0.4%	0.3%	0.4%	0.4%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

Source: Company documents

Application development and maintenance revenue pie has declined over the past decade from 55.8% in FY04 to 35.1% in 2Q14.

Application development and maintenance revenue pie has declined over the past decade from 55.8% in FY04 to 35.1% in 2Q14. We believe that this decline is due to INFY's pricing strategy that has always sought to maintain premium over other vendors and in the process losing out on contracts. Also Infosys 3.0 strategy to increase revenue from consulting and system integration service line, which comprises discretionary spend by the client and hence commands higher pricing, has failed to take off as expected. INFY's biggest rival, TCS, has in the meantime grown its ADM business at a substantially higher rate than that of Infosys (Figure 7). For TCS, ADM comprised 41.4% of total revenues in 2Q14 while Cognizant derived almost half of its revenues from ADM.

TCS has grown its ADM business at a substantially higher rate than that of Infosys

Figure 8: ADM growth rates of TCS are substantially more than that of Infosys

YoY growth rates	2009	2010	2011	2012	2013	1Q14	2Q14
TCS	8.4%	23.5%	18.7%	26.2%	23.2%	18.2%	30.0%
Infosys	4.3%	0.4%	18.4%	14.3%	1.4%	4.7%	5.1%

Note: Growth rates based on INR data

Source: Company documents

Still, INFY boasts of excellent fundamentals (FCF, ROIC, gross and operating margin)

INFY has consistently good FCFs over the past decade and generated FCF at 20.7% of its operating assets in the latest quarter

We take a look at recent performance of INFY to get an idea about its operating performance. INFY has consistently good FCFs over the past decade (Figure 9) and generated FCF at 20.7% of its operating assets in the latest quarter (Figure 10). However, total cash flow to total funds invested is in single digits as INFY always directs significant amount of FCF into cash reserves (figure 10)

Figure 9: Consistent good FCF generation in the last decade

in INR crore	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	1Q14	2Q14
Gross Cash Flow	1,419	2,086	2,855	4,153	4,895	6,744	6,904	7,339	8,878	9,846	2,602	2,527
Less: Gross Investment	-338	-1,526	-1,652	-2,818	-2,519	-2,062	-1,216	-3,766	-3,980	-5,376	-1,555	-555
Free Cash Flow	**1,081**	**560**	**1,203**	**1,336**	**2,376**	**4,682**	**5,687**	**3,573**	**4,898**	**4,470**	**1,046**	**1,972**
Add: Non operating cash flow	-1,068	-95	-1,442	-1,164	-1,751	-2,540	-4,322	-34	-2,710	-1,436	722	-2,109
Total cash flow	13	464	-239	172	625	2,142	1,365	3,539	2,188	3,034	1,769	-137
Cash flow to debt holders	-11	3	-62	-40	-41	69	-54	-94	-122	-35	-36	-133
Cash flow to minority and preference share holders	-45	0	47	75	4	0	0	0	0	0	0	0
Cash flow to equity holders	68	462	-224	137	662	2,073	1,419	3,633	2,310	3,069	1,805	-4

Source: Company documents

Figure 10: Good FCF generation rates (FCF/ invested capital)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	1Q14	2Q14
FCF/ Operating capital	37.5%	13.9%	19.2%	16.4%	25.5%	49.1%	58.1%	28.5%	31.7%	19.4%	21.0%	20.7%
Total cash flow/ Total funds invested	0.3%	8.0%	-2.8%	1.4%	3.8%	10.6%	5.4%	12.2%	6.1%	7.1%	5.9%	5.3%

Source: Company documents

Figure 11: Substantial amount of FCF is diverted to cash

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
% of FCF diverted to cash	32.4%	-34.1%	150.0%	173.5%	44.6%	56.5%	14.8%	124.8%	77.6%	24.8%

Source: Company documents

Next, we take a look at current valuations of companies that have similar ROICs to that of INFY's (Figure 12). We beleive that companies with consistently high ROICs (in excess of 30%) command a Price /Average three year earnings ratio in excess of 18.

Figure 12: ROIC vs FCF of some high ROIC generating Indian companies

	ROIC	P/E
INFY	47.8%	19.9
TCS	43.4%	25.1
Bajaj Auto	45.0%	18.0
Hero Motocorp	28.2%	20.0

Source: Analyst estimate, Capital IQ, Google Finance

INFY still earns ROIC of 40% on the back of 40% gross margin and operating margin above 20% justifying premium P/E associated with INFY stock price. We believe that INFY will continue to earn ROIC above 35% in the near term due to improving demand environment in US.

We note that INFY still earns ROIC of 40% (Figure 13) on the back of 40% gross margin and operating margin above 20% justifying premium P/E associated with INFY stock price. We believe that INFY will continue to earn ROIC above 35% in the near term due to improving demand environment in US.

Figure 13: Excellent fundamentals justify INFY's premium price multiple

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	1Q14	2Q14
ROIC excluding goodwill and intangibles	78.3%	81.4%	70.4%	74.3%	64.2%	73.3%	68.0%	61.4%	59.4%	53.5%	49.6%	45.7%
ROIC including goodwill and intangibles	75.3%	78.5%	69.2%	69.7%	58.5%	67.4%	62.1%	56.2%	54.7%	47.8%	43.3%	39.8%
Operating cash tax rate	16.2%	16.1%	13.0%	10.7%	14.7%	13.6%	22.1%	27.7%	26.7%	25.8%	25.0%	32.7%
Pretax ROIC excluding goodwill and intangibles	93.5%	97.1%	81.0%	83.2%	75.3%	84.8%	87.3%	84.9%	81.0%	72.1%	66.1%	67.9%
Pretax ROIC including goodwill and intangibles	89.9%	93.5%	79.5%	78.1%	68.6%	78.1%	79.8%	77.7%	74.7%	64.4%	57.7%	59.1%
Revenues/Invested Capital without goodwill and acquired intangibles	3.2	3.3	2.8	2.9	2.5	2.7	2.6	2.7	2.6	2.6	2.6	2.9
Revenues/Invested Capital with goodwill and acquired intangibles	3.0	3.1	2.8	2.7	2.3	2.5	2.4	2.5	2.4	2.3	2.2	2.5
Operating margin	29.6%	29.8%	28.8%	28.9%	29.6%	31.4%	33.1%	31.5%	31.0%	27.8%	25.7%	23.8%
Gross Margin	48.4%	48.0%	47.5%	47.1%	46.3%	47.1%	49.1%	47.0%	45.7%	41.7%	39.4%	39.3%
SG&A/Revenues	14.8%	14.4%	14.3%	14.7%	13.4%	12.5%	12.2%	12.6%	12.2%	11.5%	11.3%	13.4%
Depreciation/Revenues	4.2%	4.0%	4.6%	3.7%	3.6%	3.5%	4.0%	3.1%	2.7%	2.7%	2.7%	2.4%
Operating working capital/ Revenues	4.8%	5.1%	8.7%	9.4%	11.5%	11.6%	10.8%	11.1%	13.6%	14.3%	14.8%	13.1%
R&D expense/ Revenues	0.9%	1.0%	1.1%	1.2%	1.2%	1.1%	1.9%	1.9%	2.0%	2.3%	2.2%	2.0%
Other assets/ Revenues	5.2%	4.3%	3.5%	2.2%	1.7%	1.1%	2.1%	3.5%	3.3%	2.8%	2.5%	2.2%
Fixed Assets/Revenues	20.6%	19.8%	21.6%	21.3%	23.9%	21.9%	21.9%	18.9%	17.4%	17.0%	16.8%	15.4%

Source: Company documents, Analyst estimate

Excellent fundamentals support current price levels

INFY's valuation multiples and recent price history (Figure 14 and 15) suggests that improved revenue prospects after declaration of 2Q14 results have been priced in.

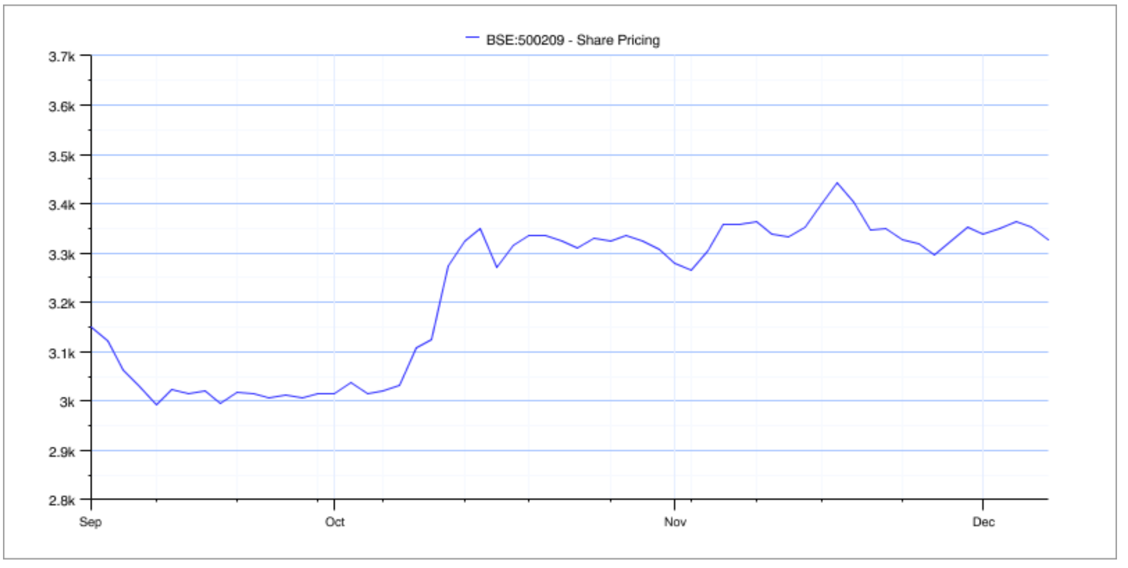
Figure 14: Valuation multiples do not imply underpricing

INR except for ratios	
Price	3,327
Price/Book	5.0
Price/FCF	43.6
FCF yield	2.3%
Earnings/Share	42.1
Price/Earnings	19.9
Earnings yield	5.0%
Price/ Average of three year EPS	20.9
Price/ forward EPS	18.7
Net EV/EBITA	14.4
Dividend yield	1.6%

Given INFY's solid operating fundamentals, we advocate long term Price/ (Average three years earnings) range of 20-22 in spite of some of the issues discussed earlier. Our FY14 P/E estimate assumes USD revenue growth rate of 11.1% and INR earnings growth rate of 7.8% for FY14. Price/ (Average three years earnings) range of 20-22 gives us price range of INR3,254-3,579 leading to a "HOLD" recommendation.

Source: Analyst estimate, Google Finance

Figure 15: Recent price history suggests improved revenue prospects have been priced in



Source: Capital IQ

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We also identify following risk factors that may lead to short term downside in INFY's stock price:

1) Further weakness in growth of ADM revenues due to premium pricing strategy.
2) Drastic appreciation of INR against USD.
3) We do not expect recent top level management exits to have a serious impact on INFY's stock price in the short term as most of these exits seem to be a part of top level management rejig. However, these changes may have an impact in midterm on INFY's stock price.

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