

INFOSYS

IT - SERVICES

28 MAR 2018

Visit Note

BUY

Target Price: Rs 1,345

Steady outlook with focus on execution

We spoke to Infosys' management about demand environment and near term growth/margin triggers. Management cited confidence in delivering growth in line with the guidance. We expect steady Q4FY18 performance, an early sign of pick-up in demand, as Q4 tends to be an unpredictable quarter. We expect commentary to indicate improvement in demand with continued journey of strategy execution.

Early leg of rerating: Infosys is trading at discount to its historical average. We believe as the management team stabilizes, with key focus on execution of strategic initiatives undertaken by the team along with continued focus on regaining market share, Infosys is in early stage of rerating cycle. We expect growth recovery to be led by BFSI, Energy, and Telecom verticals wherein large deal wins, client mining, and wallet share gain have improved revenue visibility.

CMP : Rs 1,162
Potential Upside : 16%

MARKET DATA

No. of Shares : 2,184 mn
Free Float : 87%
Market Cap : Rs 2,538 bn
52-week High / Low : Rs 1,220 / Rs 862
Avg. Daily vol. (6mth) : 4.9 mn shares
Bloomberg Code : INFO IB Equity
Promoters Holding : 13%
FII / DII : 36% / 22%

Revenue visibility with margin resilience

- ♦ **Improved growth visibility in larger verticals – BFSI/Energy/Telecom (~50% of revenue):** Infosys neither changed nor narrowed its FY18 guidance range after Q3FY18 despite only one quarter of execution left. The management cited positive outlook for few verticals: **(i) BFSI – Increased spend:** Soft performance in Q3FY18 was attributed to delay in project ramp-up in the vertical. The management continues to see improvement, as clients increase spend in CRG (Compliance, Risk & Governance) and business (Digital) yielding strong deal pipeline in the vertical. The vertical may post double digit growth in FY19. The management's optimism is also driven by deal signed in first three quarters (that witnessed slow ramp-up in Q3FY18 contrary to anticipation due to furloughs). Insurance vertical is witnessing strong traction with demand for core system modernization and increased digital adoption in improving customer experience. **(ii) Telecom – Gaining market share:** The growth in the vertical continues to be ahead of peers led by wallet share gain with existing clients. The deals are largely in application maintenance and BPO at competitive pricing, but automation is helping delivering steady margin. Moreover, the company continues to gain new clients in the vertical.

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Financial summary (Consolidated)

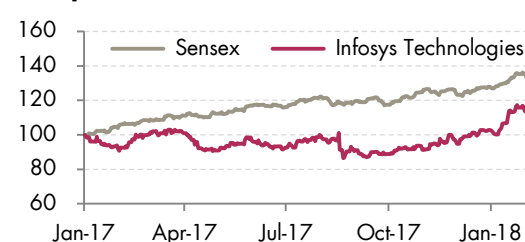
Y/E March	FY17	FY18E	FY19E	FY20E
Sales (Rs bn)	685	707	789	866
Adj PAT (Rs bn)	144	161	163	180
Con. EPS* (Rs)	-	68	70	77
EPS (Rs)	63	70	72	79
Change YOY (%)	6.4	12.0	2.0	10.3
P/E (x)	18.5	16.5	16.2	14.7
RoE (%)	22.0	24.9	25.7	25.3
RoCE (%)	30.4	31.2	34.2	34.0
EV/E (x)	11.5	11.9	10.5	9.2
DPS (Rs)	26	33	42	42

Source: *Consensus broker estimates, Company, Axis Capital, CMP as on 21- March 2018

Key drivers

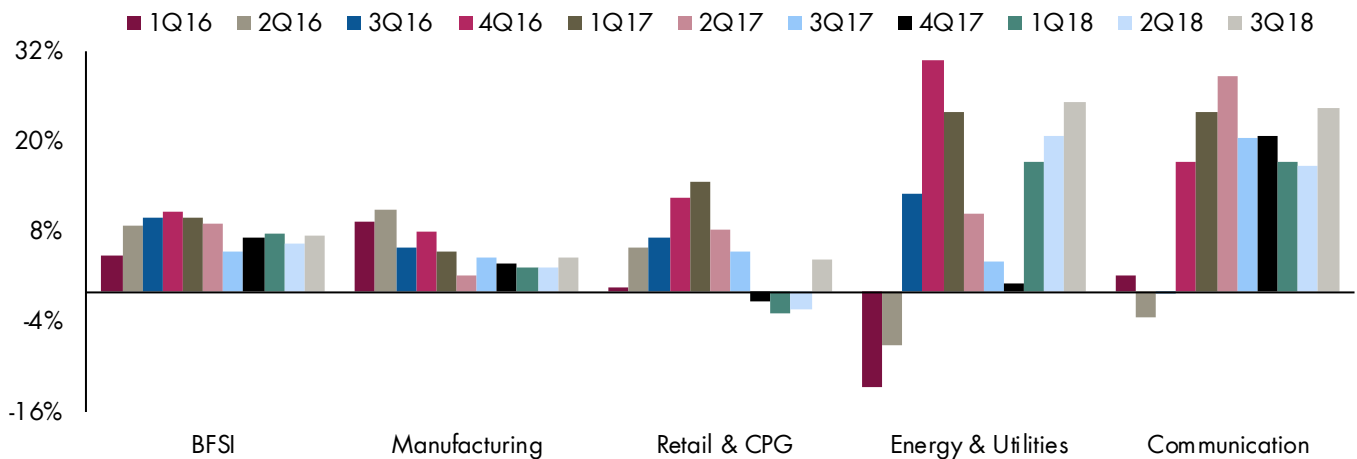
	FY17	FY18E	FY19E	FY20E
USD revenue (bn)	10,208	10,916	11,901	13,058
% change YoY	7%	7%	9%	10%
EBITDA margin	27%	27%	26%	26%

Price performance



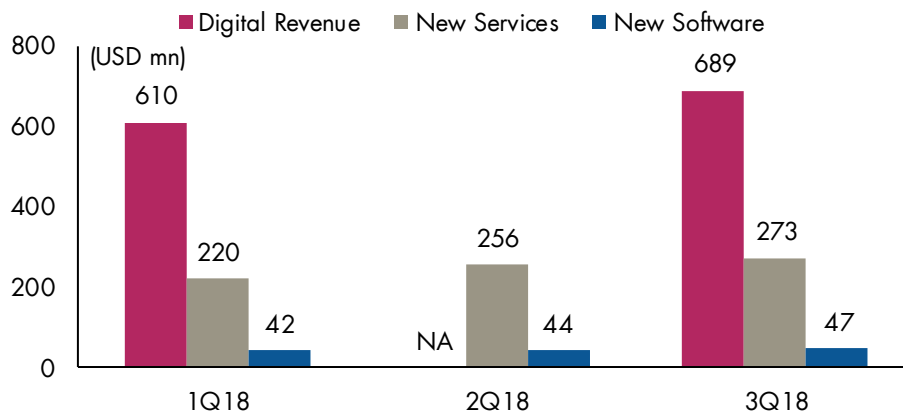
We expect double-digit growth for the vertical in FY19. **(iii) Energy/Manufacturing – Improving fundamental:** Revenue visibility has improved over the last few quarters, as stability has returned in the vertical due to better price for crude. According to the management, clients have redrawn their strategic initiatives in new pricing environment of crude aligned to long-term business outlook. We expect steady recovery to double digits by Q4FY19 in the vertical, as spend returns.

Exhibit 1: Key vertical like BFSI, Communications and Energy witnessing recovery



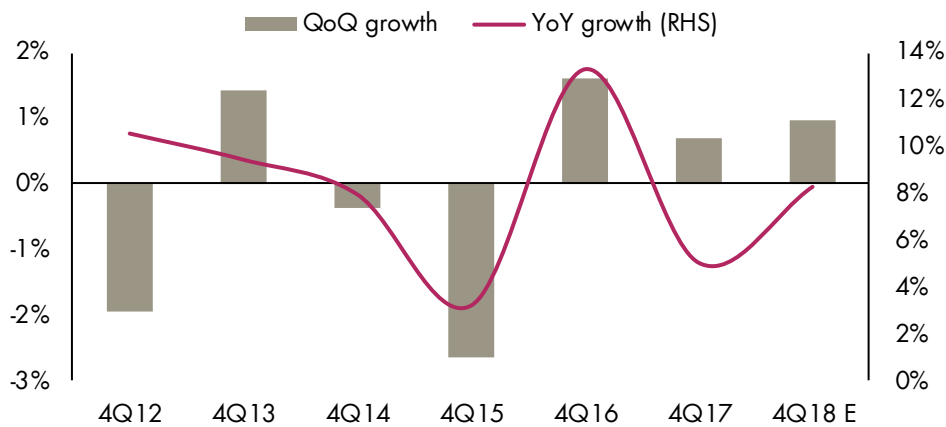
Source: Company, Axis Capital

Exhibit 2: Digital gaining scale

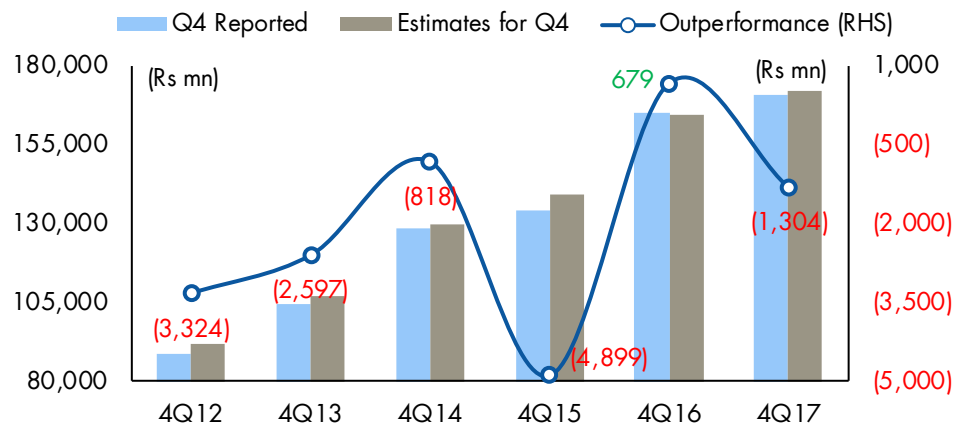


Source: Company, Axis Capital

- ♦ **Q4 seasonality and FY19 guidance:** Q4 tends to be a quarter with negative surprise historically. An in-line or better than expected quarter would set tone for stronger FY19. We don't expect a steep target for FY19 as it would be first financial year of his leadership. We expect conservative guidance to set the tone of traditional Infosys style of "Beat and Raise", which is likely to be re-enforced by Nandan Nilekani (Co-Founder, Non-Executive Chairman)

Exhibit 3: Q4 growth has been volatile for Infosys, hampering the exit rate


Source: Company, Axis Capital

Exhibit 4: Q4 tends to be quarter of negative surprises


Source: Company, Axis Capital

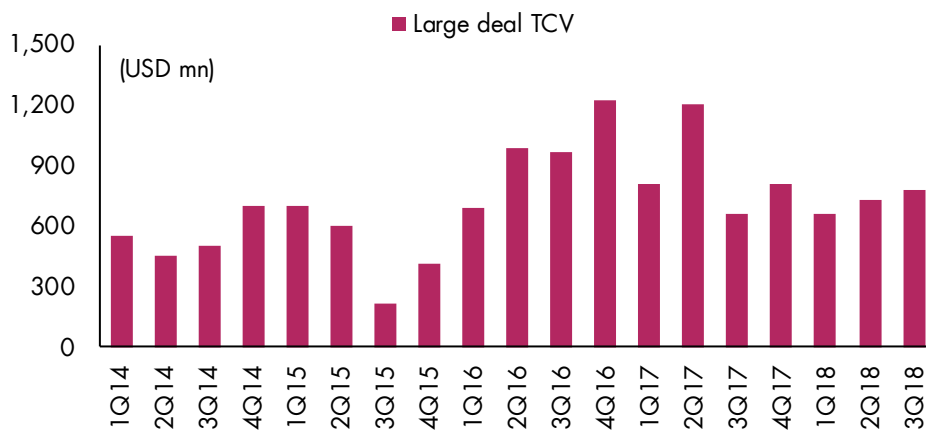
- ♦ **Strong processes demonstrated by stable performance despite attrition:** Infosys' financial performance barely got impacted after Dr Vishal Sikka's exit. We see the tumultuous time, which started with public debate between founders/promoters and Dr Sikka, largely behind. We see limited risk of attrition at senior management (key management professional) in the near term. Moreover, the financial performance of the company continues to improve. We expect steady improvement in financial performance despite senior management departures as an evidence of strong processes that the company possess

Exhibit 5: Churn in key leadership positions is largely behind

Date	Name	Designation
Apr-17	Mate Radalj	AVP and principal Technologist
Apr-17	Sheenam Ohrie	VP and Head-delivery and Testing, Finacle
May-17	Gordon Muehl	VP and Head- Infosys Germany
Jun-17	Sandeep Dadlani	President and Head of Americas
Jun-17	Anand Sinha	AVP - Finance
Jul-17	Ritika Suri	Executive VP - Corporate Development and M&A
Jul-17	Yusuf Bashir	MD - innovation Fund
Jul-17	Anirban Dey	Global head and Chief business officer of Edge products and EdgeVerve
Sep-17	Sanjay Rajagopalan	Head - Design Thinking
Sep-17	Navin Budhiraja	SVP, Head - Architecture and Technology
Oct-17	Abdul Razack	SVP
Oct-17	Pervinder Johar	CEO - EdgeVerve

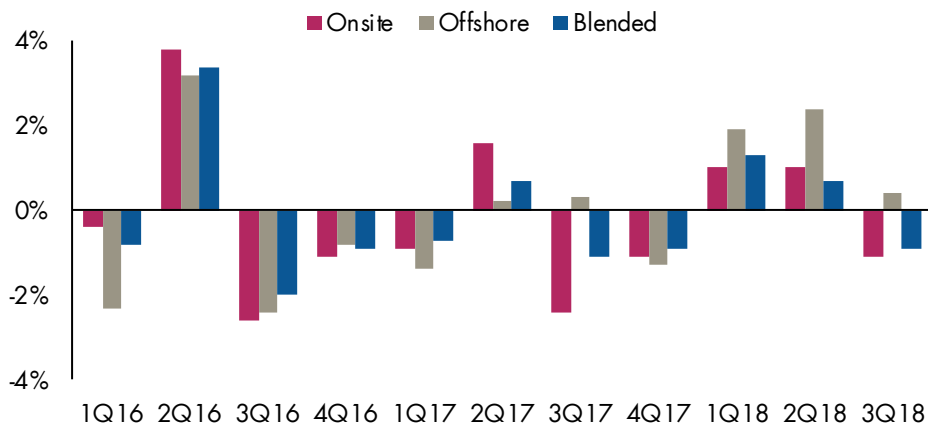
Source: Company, Axis Capital

- ♦ **Deal pipeline and deal closure – Improved visibility:** Visibility of deal pipeline has improved. Nevertheless, there has been limited improvement in the pipeline over past 1-2 quarters. The company has shown limited appetite for USD 1 bn+ deal that its peers like TCS and Cognizant have closed in recent past. The margin profile of these deals over the tenure of the deal remains key concern area for the company. Moreover, there has been steady increase in deal sizes for Digital contracts along with number of deals in the pipeline

Exhibit 6: Large deal closures are healthy but need to inch up to USD 1 bn

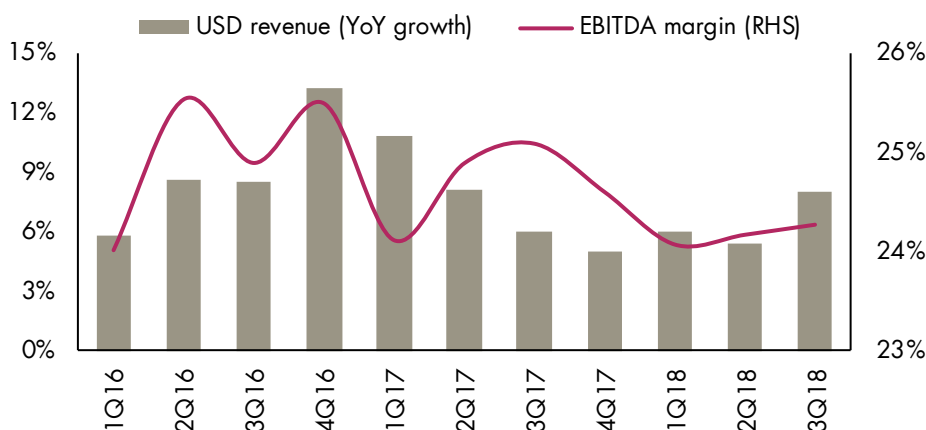
Source: Company, Axis Capital

- ♦ **Pricing environment – No change:** The challenges of pricing pressure on legacy is still there with no major change in environment. However, the effort of the management is to retain blended realization by higher growth in Digital, along with automation, and productivity improvement (headcount addition slower than revenue addition). Overall, realization has been flattish in constant currency terms

Exhibit 7: Blended realizations in a narrow band (QoQ)

Source: Company, Axis Capital

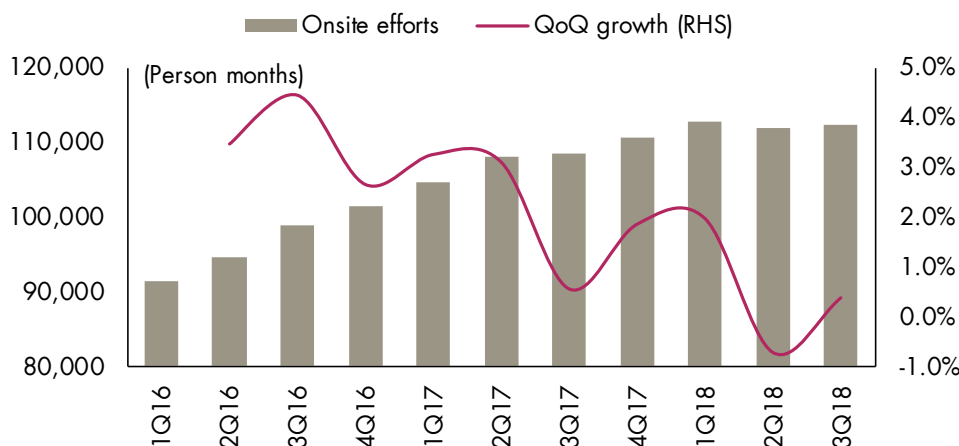
- ◆ **Operating margin resilient despite downward revision in growth:** Infosys has delivered stable margin despite (i) downward revision in guidance (from 7.5% to 6.5% in constant currency terms at mid-point), (ii) higher variable pay, and (iii) continued pricing pressure on legacy. The margin resilience was largely led by higher offshore mix, onsite pyramid (hiring fresher), project specific cost optimization measures, higher mix of revenue from newer technologies at higher price, and higher proportion of fixed price projects. Moreover, driving new services including Digital at higher price points would cushion the margin pressure. The management is confident of retaining margin in the guided range. Our conservative estimates factors ~50 bps margin erosion over FY17-20E

Exhibit 8: Revenue momentum steady; will aid margin

Source: Company, Axis Capital

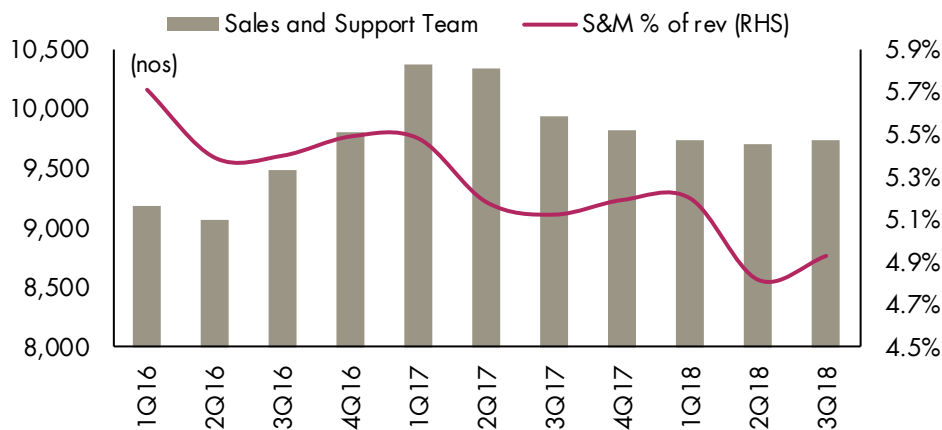
- ♦ **Onsite investments – Centers would have similar pyramid as offshore:** Infosys has announced new centers in the US at Hartford, Indianapolis, Rhode Island, and Wisconsin. These centers of technology and innovation hubs would focus on technology areas like artificial intelligence, machine learning, user experience, emerging digital technologies, cloud, and big data. These hubs will not only have technology and innovation focus areas, but will closely serve clients in key industries such as financial services, manufacturing, healthcare, retail, energy and others
 - The company is planning to increase local hiring to reduce visa dependence. Moreover, the company will try to maintain employee pyramid at onsite to bring the overall cost of operations. The company is committed to hire ~10k over FY18-19E (~2.5k hired in Q1-Q3FY18). It is hiring from tier-2/3 and community colleges. The onsite pyramid has no negative impact on the financial and business model of the company, as it plans for onsite training facility also. According to the management, there is still room of onsite cost optimization. We see this as one of the margin levers for the company

Exhibit 9: Onsite presence likely to witness more local addition and less visa dependence



Source: Company, Axis Capital

- ♦ **Investment in sales – To improve client reach:** Despite increasing competitive intensity, Infosys made limited addition in the sales team over the last 2 years. We expect Infosys to ramp up the sales team to increase its client reach over the next 4-6 quarters. However, the company will optimize the investment in the same to limit the impact on the margin

Exhibit 10: S&M team likely to see ramp-up


Source: Company, Axis Capital

Estimates and valuations – Rerating with steady performance

Infosys' financial performance has been resilient over past few quarters. The company has been slowly regaining market share in select verticals. We expect financial performance to improve steadily led by revival in few verticals. We expect revenue growth in USD terms to be on an upward trajectory (7%/9%/10% in FY18/FY19/FY20) with stable margin. We believe stability at senior management, steady revenue growth with consistent strategic outlook over FY18-20E, better capital allocation, and improving revenue outlook will drive rerating. We retain our BUY rating with target price of Rs1,345 (17x FY20E EPS) implying upside of 16% from CMP of Rs 1,162. The stock trades at 16x/15x FY19E/20E EPS of Rs 72/ Rs 79.

Financial summary (Consolidated)

Profit & loss (Rs bn)

Y/E March	FY17	FY18E	FY19E	FY20E
Net sales	685	707	789	866
Other operating income	-	-	-	-
Total operating income	685	707	789	866
Cost of goods sold	(416)	(434)	(488)	(535)
Gross profit	269	273	302	331
<i>Gross margin (%)</i>	<i>39</i>	<i>39</i>	<i>38</i>	<i>38</i>
Total operating expenses	(83)	(84)	(94)	(103)
EBITDA	186	189	207	228
<i>EBITDA margin (%)</i>	<i>27</i>	<i>27</i>	<i>26</i>	<i>26</i>
Depreciation	(17)	(19)	(18)	(18)
EBIT	169	170	190	209
Net interest	-	-	-	-
Other income	30	33	31	35
Profit before tax	200	204	220	245
Total taxation	(56)	(43)	(57)	(65)
<i>Tax rate (%)</i>	<i>28</i>	<i>21</i>	<i>26</i>	<i>26</i>
Profit after tax	144	161	163	180
Minorities	-	-	-	-
Profit/ Loss associate co(s)	-	-	-	-
Adjusted net profit	144	161	163	180
<i>Adj. PAT margin (%)</i>	<i>21</i>	<i>23</i>	<i>21</i>	<i>21</i>
Net non-recurring items	-	-	-	-
Reported net profit	144	161	163	180

Balance sheet (Rs bn)

Y/E March	FY17	FY18E	FY19E	FY20E
Paid-up capital	11	11	11	11
Reserves & surplus	678	590	657	742
Net worth	690	600	668	753
Borrowing	-	-	-	-
Other non-current liabilities	4	9	9	9
Total liabilities	693	610	677	762
Gross fixed assets	247	263	282	303
Less: Depreciation	(86)	(102)	(119)	(138)
Net fixed assets	161	161	163	165
Add: Capital WIP	-	-	-	-
Total fixed assets	161	161	163	165
Other Investment	-	19	-	-
Debtors	123	134	146	160
Cash & bank	390	300	368	449
Loans & advances	-	-	-	-
Current liabilities	140	162	181	198
Net current assets	461	374	440	522
Other non-current assets	71	75	75	75
Total assets	693	610	677	762

Source: Company, Axis Capital

Cash flow (Rs bn)

Y/E March	FY17	FY18E	FY19E	FY20E
Profit before tax	200	204	220	245
Depreciation & Amortisation	17	19	18	18
<i>Chg in working capital</i>	<i>(19)</i>	<i>(7)</i>	<i>3</i>	<i>(1)</i>
Cash flow from operations	111	139	153	161
<i>Capital expenditure</i>	<i>(26)</i>	<i>(18)</i>	<i>(20)</i>	<i>(21)</i>
Cash flow from investing	5	15	11	15
<i>Equity raised/ (repaid)</i>	<i>(12)</i>	<i>(174)</i>	-	-
<i>Debt raised/ (repaid)</i>	-	6	-	-
<i>Dividend paid</i>	<i>(59)</i>	<i>(76)</i>	<i>(96)</i>	<i>(96)</i>
Cash flow from financing	(71)	(244)	(96)	(96)
Net chg in cash	45	(90)	69	81

Key ratios

Y/E March	FY17	FY18E	FY19E	FY20E
OPERATIONAL				
FDEPS (Rs)	63	70	72	79
CEPS (Rs)	70	78	80	87
DPS (Rs)	26	33	42	42
Dividend payout ratio (%)	41	47	59	53
GROWTH				
Net sales (%)	10	3	12	10
EBITDA (%)	9	2	10	10
Adj net profit (%)	6	12	2	10
FDEPS (%)	6	12	2	10
PERFORMANCE				
RoE (%)	22.0	24.9	25.7	25.3
RoCE (%)	30.4	31.2	34.2	34.0
EFFICIENCY				
Asset turnover (x)	2.4	2.4	2.6	2.9
Sales/ total assets (x)	0.9	0.9	1.0	1.0
Receivable days	66	69	68	68
FINANCIAL STABILITY				
Current ratio (x)	4.3	3.3	3.4	3.6
VALUATION				
PE (x)	18.5	16.5	16.2	14.7
EV/ EBITDA (x)	11.5	11.9	10.5	9.2
EV/ Net sales (x)	3.1	3.2	2.8	2.4
PB (x)	3.9	4.4	4.0	3.5
Dividend yield (%)	2.2	2.9	3.6	3.6

Source: Company, Axis Capital

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