Emkay Research

26th August'2008

HOLD

Price	Target Price
Rs1,706	Rs1,836
Sensex	14,450

Price Performance

(%)	1M	3M	6M	12M
Absolute	6	(9)	7	(6)
Rel. to Sensex	10	7	29	(8)

Source: Capitaline

Stock Details

Sector	IT Services
Reuters	INFY.BO
Bloomberg	INFO@IN
Equity Capital(Rs mn)	2862
Face Value(Rs)	5
52 Week H/L	2,140/1,212
Market Cap(Rs bn//US$ mn)	960/22,365
Daily Avg Volume (No of shares)	2169533
Daily Avg Turnover (US$)	86.9

Shareholding Pattern (%)

(31st March'08')

Promoters	16.5
FII/NRI	53.3
Institutions	7.9
Private Corp.	3.1
Public	19.2

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Infosys Technologies

Company Update

Q&A time: Questions for mgmt on Axon at the meet

Infosys has made the right strategic foray by announcing intent to acquire Axon Group PLC late on Monday. The acquisition (1) expands Infosys's transformation consulting capabilities and with this move Infosys at ~4,100 consultants now has the 2nd largest SAP headcount among offshore players ***(Axon Group is regarded as a respectable niche player in SAP consulting as per industry research)***, (2) Increases share of European business, (3) provides some notable client additions that include British Telecom, BP, Xerox, Vodafone, Barclays Bank, AstraZeneca amongst others. ***(for our 1st read on the acquisition please refer to the note: Infosys Tech: Inorganic push coming at a price released earlier in the day).*** Although we appreciate the intent for the above move given that it addresses some investor concerns on Infosys's high cash balances and lack of inorganic moves unlike more aggressive steps by peers like Wipro, TCS and lately by HCL Tech and Satyam as well ***(although they remain small tuck in acquisitions only)*** we note that the company management needs to address certain issues at tomorrow's analyst meet which remain critical for the successful integration of Axon and the likely benefits from it. We summarize some of them below.

Likely Growth trajectory for the acquired entity

Axon has recorded ~ 43% revenues and ~68.2% reported profits CAGR over CY03-CY07 (albeit this includes contribution from ~11 acquisitions completed by Axon till date as well). We note that Axon already enjoys ~15%+ market share in the SAP implementation market in UK with the Axon management having publicly acknowledged of significant tapering off in growth rates in the company's stronghold. ***(Substantiated further by the company's 1HCY08 results, Axon's revenues from EMEA up by only ~12 % YoY V/s Company wide growth rate of ~ 28%, for a complete snapshot of Axon's 1hCY08 results refer Table 1)***

We would wish to query Infosys management more on the likely growth trajectory for the acquired entity given that the inherent company management has indicated recent pricing weakness in some new client wins as well as in the backdrop of the worsening macro environment. ***(we believe that Enterprise IT spend that has remained strong since 2003 could come under some pressure in case of a prolonged weak business environment)***

Axon's high client concentration; possible cross selling opportunities???

Infosys management has indicated during the investor call that Axon has certain marquee client names like BP, BT, Vodafone, Xerox and AstraZeneca amongst others as well the company commenting that there is a minimal overlap on the client list. Besides on certain public forums, Axon has indicated of a Top 5 client concentration of ~54% and a Top 10 client revenue contribution at ~64%. We believe it is important for investors to ascertain which client names feature amongst Axon's top clients because that remains paramount to Infy's ability to cross sell as well as to expand size of client engagement. Further as Axon derives ~20% of revenues from Business Consulting (Source: Company), it becomes important to understand whether this can give fillip to Infosys's mixed performance in the consulting business until now. ***(Consulting presence improves vendor's chances for bagging significant amount of downstream business)***

Margin roadmap for Axon

Axon reported ~15% EBIT margins in CY07, considerably lower than Infosys's reported FY08 EBIT margins at ~27.8%. Axon's H1CY08 results have shown some weakness in company wide operating margins at 13.4% ***(company's growth rates from higher margin EMEA geography is just 12%, with majority of the growth led by America where margins are significantly lower).***

Although Infosys management indicated during the call yesterday that there existed some opportunities to enhance margins at Axon, the management remained non committal on any targets for the same. We believe that it is imperative for investors to understand what kind of operational efficiencies Infosys can drive at Axon given Axon's high onsite centric consulting business in order to bridge the margin gap between the two entities.

Sustainability on Axon's high revenue productivity

Our 1st cut analysis reveals that Axon's revenue productivity is ~6x Infy's average revenue/employee at ~US$ 3,00,000 p.a (V/s a comparable figure for Infosys at ~US$ 50,000 p.a) with the strength driven from the strong demand for SAP consulting/implementation since 2003. In the backdrop of the worsening business environment as well as Axon's management's comments on some form of price weakness in new contract signings, we would like to catch the company's sound bytes about the sustainability of Axon's high revenue/employee.

Key personnel retention: How big is the challenge?

We note that Infosys could face a potent challenge in the form of retaining the high end consulting talent given that in case of some earlier acquisitions by other peers the retention record has been bad. We believe Infosys would face some sort of a challenge on this count as Axon's high paid employees get acquired by an Indian company which boasts of ~96% of Indian workforce. Hence we would like to understand from the Infosys management on how do they intend to address the employee retention issue at the acquired entity.

Media reports of a counter bid; would Infy get into aggressive bidding?

As we write this note, Reuters reports that there could be a likely counter bid for Axon Group PLC at ~GBP 7/share, at ~16.6% premium to Infosys's offer price of GBP 6/share leading to a 20% spike in Axon's stock price. We have been worried on the possibility of aggressive counter bidding on the target company ***(we highlighted that as a risk in our note earlier in the day as Axon has large institutional share holding) because an aggressive price war on the target could lead to Infosys overpaying for Axon.***

Large institutional holding in the stock could make the overall buyout process difficult for Infosys.

Holder Name	Amt	% Stake
Standard Life Investment	4,529,610	7.04
Standard Life Investment	4,513,069	7.02
Blackrock Inv Management	4,149,157	6.45
Aegon UK PLC	3,852,325	5.99
Aegon UK PLC	3,528,470	5.49
UBS AG	3,220,277	5.01
JP Morgan Chase & Co	3,083,162	4.79
JP Morgan Asset Mgmt	3,083,162	4.79
Lloyds TSB Group PLC	2,758,945	4.29
Scottish Widows Invest	2,654,693	4.13
Total	**35,372,870**	**55**

Although Infosys has limited acquisition history, we believe that going by Infy's inherent conservative nature as such ***(numerous industry precedents when Infy has walked out of deals/business with a clear focus on protecting/maintaining margins)***, the company would not get into an aggressive price war and run the risk of overpaying and prolonging the payback on the deal.

Maintain zero impact for FY09 earnings; ~1.4% accretion to FY10 earnings

We maintain that Axon would make zero impact on our FY09 earnings estimates while addition to FY10 earnings estimates could be ~1.4% on the basis of the no revenue/cost/margin synergies (based on Reuters consensus estimates for Axon Group PLC).

We wish to add that although Infy's possible buyout of Axon signals a new found aggressive pursuit for acquiring consulting capabilities and could signal a new phase for the company, it remains financially neutral near term. We maintain our 'HOLD' rating on the stock with a price target of Rs 1836.

Table 1:A snapshot of Axon's H1CY08 performance

(in GBP mn except %)	H1CY08	H1CY07	% change
Revenues	**123.9**	**96.7**	**28.2**
Cost of Sales	92.0	69.0	
Option Expenses	2.0	0.9	
Gross profits	29.9	26.8	**11.8**
Gross profit mgns,%	*24.2*	*27.7*	
Other op Income	0.1	0.1	
G& A expenses	11.8	11.3	
EBITA	**18.2**	**15.5**	**17.1**
EBITA mgns,%	*14.7*	*16.1*	
Amortisation of Intangibles	1.6	1.7	
EBIT	16.5	13.8	**19.5**
EBIT mgns,%	*13.4*	*14.3*	
Investment Income	0.4	0.1	
Interest Costs	0.6	0.6	
Profit before Taxes	16.3	13.4	
Taxes	5.4	5.0	
Net profits	**10.8**	**8.4**	**28.8**
Net profit mgns,%	*8.7*	*8.7*	

Source:Company, Emkay Research

£'000	H1CY08	H1CY07	%Growth
EMEA			
Revenue	69556.0	62070.0	12.1
Operating Profit	14449.0	11155.0	29.5
OPM%	20.8	18.0	15.6
Americas			
Revenue	52035.0	34578.0	50.5
Operating Profit	2307.0	2554.0	-9.7
OPM%	4.4	7.4	-40.0

Source:Company, Emkay Research

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