



Analyst Meet

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Theme Address

Nandan M. Nilekani

Chief Executive Officer, President and Managing Director

Thank you and it is a great pleasure for all of us to have you here in Pune. This is the first event we are having in this brand new building and we are indeed delighted that you are here. Over the next half an hour or so, I will try to define what is happening in the market place, what is happening to the business model, why Infosys is different, and how we see the various things from our both operational and strategic point of view. The focus of this presentation is really trying to define how we expect to meet the challenges of the global market place.

One of the key things which has happened in the last couple of years is clients are increasingly viewing their technology spending with a far more disciplined eye. Over the last 40 years as you know, technology spending has grown in double digits as compared to single digit growth of GDP, and today technology spending and IT spending is more than 50% of the capital spending of large businesses in the US. But, in last couple of years when there has been an economic challenge, when the people are not able to raise their prices, when the profits are under pressure, there is a large amount of looking at by top management on their IT spending, and trying to thoroughly make sure that their IT spending is contained, also trying to make sure that the IT spending is aligned with their business spending, and when more and more people look at technology spending, they want to make sure there is an immediate return on investment. Therefore, you have seen this period where people are actually seeing IT budgets being flat or declining.

Now, this has resulted in several actions by IT department of large corporations. For example, outsourcing is not just one of the things, they are doing many other things. As you know there is a big trend going towards Intel-based low-cost servers, running Windows and Linux as opposed to proprietary operating systems. There is a move towards using open source software in corporations. So, there are many many different things that the companies are doing. The companies are trying to get the full value of the investments made in buying enterprise applications, and they have looked at outsourcing as one of the means to go forward, and therefore offshoring and outsourcing have become more and more mainstream.

This has actually coincided with the fact that leading Indian firms like Infosys have also been able to provide the size, scale, and maturity that is required to meet this challenge of outsourcing. So, in a sense, the most important development of the last couple of years has been the increasing effort of corporations to minimize and contain their IT spending and the corollary effect, which is that outsourcing and specifically offshoring and specifically to India has become mainstream. Now, this has resulted in a situation where customers themselves are driving this change and that is the point which we need to recognize: that customers are demanding having tasted the value of offshoring, which gives them superior quality and superior value at half the price, customers themselves are demanding offshoring, and today in almost every major, more than 90% of the firms today are either doing some kind of an offshore initiative in terms of actually doing work offshore or are contemplating doing that through a variety of means. As a result, we believe this has put a pressure point on the incumbents. The incumbents have not historically chosen to go offshore, because offshore has certain cost for them, but the increasing demands from the customer for the value and quality and price benefits of offshore has led to incumbents also being requested by their customers to provide offshore capabilities. And as you would have noticed in the last year or so, every major incumbent has made announcements about how they intend to offer some kind of an offshore capability.

But as Bala mentioned in his opening remarks, going offshore is not really just about hiring people, there is a lot more to that. Number one, there is a whole lot of intellectual property in the global delivery model, the global delivery model is about taking large complex software projects, disaggregating them into components, getting them done in different development centers based



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upon where it is most cost effective and where the quality of talent is high, reassembling all these components together and delivering a complete solution to the customer. It is to do with remote project management, project monitoring, knowledge management, using technology to manage seamlessly across in a border-less way, to use different time zones, to use high quality world class infrastructure of the kind we have. So there is a whole host of intellectual processes which is there in the global delivery model, and this is something which can only happen through evolution. There is no short cut to developing this, you have to do it, you have to experience it, you have to improve it, you have to hone it, you have to build tools for it, you have to build systems for it, and that process has to go on. So, I think clearly there is a lot more to the global delivery model than just hiring in some city in India.

The second thing is that our model is fundamentally a different business model. We are able to deliver value, very often superior value, at half the price, and be reasonably profitable, and for an incumbent to move to this model it requires a restructuring of the business itself. For example, they would have to let many many thousands of people go in the economies that they operate and they have to be replaced by people in India. Similarly, the revenues per employee will decline. Today, for one of the typical incumbent the average revenue per employee is about \$175,000 whereas for us it is about \$79,000. That means for every person that they replace from a high cost location to India, the revenue per person declines, and therefore they will actually have to contend with declining revenues.

The third thing is the investment in sales and marketing. Today, Infosys spends about 7.4% of revenue on sales and marketing and these firms spend about 15% of their revenue on sales and marketing. So, not only they have the challenge of the revenue declining on the per capita basis from \$175,000 to \$79,000, their spending on sales and marketing to be comparable with us on a cost basis has to decline from 15% of a larger revenue to 7.4% of a smaller revenue. So that means there is fundamentally again disruptive impact on their sales and marketing side. So, both on the delivery side there is disruption because of the relocation of development people and there is disruption on the sales and marketing side because they have to change the cost structure.

We also believe that every application service today is capable of in some way hiring some kind of an offshore content. When we began, we began with classical activities like application development, application maintenance, reengineering, but increasingly in the last few years we have been able to add new services be it enterprise solution, be it integrated testing, be it IT outsourcing, systems integration, as well as BPO, and in the last five years the proportion of revenues which comes from these new services has actually gone up from 10% of our revenue to 35% of our revenue, and this I think addition of new services has also tripled our addressable market. So the other point is that the business model is not just applicable to a few narrow services but is something which applies to a wide range of services.

The third point is that in our model, the focus is excellence in execution, excellence in delivery, making sure that the projects happen on time, on budget, within the requirements defined by the customer, and that is also the way the customer is moving, increasingly the technology strategy part is becoming more of a commodity and it is boiling on to excellence in execution, and there again I think our global delivery model evolved over the last 20 years has become the preferred way of execution. And then we have also the challenge of internal conflicts when an incumbent tries to move offshore, because to move offshore you have to wonder whether the offshore unit is a profit center, then there is a question of transfer price between the onsite activity and the offshore activity. If the offshore unit a cost center, then there is a question of motivation of people to work in the offshore center. I think our model, where managers really are responsible to seamlessly for resources both onsite and offshore and work with them as one seamless integrated team, is a much better way where there is no conflict of interest between the offshore and the onsite and therefore I think there is a fundamental model benefit that we have to offer.

And finally I think it is very very important to be able to attract the best and brightest, and here again I think the 20 years that Infosys has spent in building up its brand in India by being preferred employers, last quarter alone we received over 206,000 applications and we made 2300 offers. All



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these things are very important to make the model work. So, I think while on the one hand the model is becoming mainstream, while the customer is expecting an offshore capability from its incumbent vendors, we believe that our fundamental strategic and business benefits that accrue from our model which we will continue to benefit from. So, clearly the offshore is becoming mainstream, global delivery model is becoming mainstream, at the same time our business model is superior in this context.

Now at Infosys our focus has been consistently delivering on the promises with results. To give you an example, when we went on the ADR for primary listing in March 1999, that financial year we had revenues of \$121 million with net profit of \$30 million. This financial year ending 2004 we have given public guidance of revenues between \$966 million to \$982 million which is a 21%-22% increase in net earnings and that essentially means between \$238 million and \$239 million in net profits. That means in the space of five years our revenues would be growing from \$121 million to close to a billion dollars and net income from \$30 million to something like \$238 million to \$239 million. This growth has been made possible in the most difficult of times, in an environment where IT spending is flat or declining, in an environment where people are becoming more and more conservative and trying to make sure that they get value for money and where many IT companies have had challenges. I think this kind of growth speaks for itself.

The other important thing, which we have done which again we have to recognize, is our focus on client relationships. In the last five years from 1999 to 2003, the number of clients has gone up from 145 to 345 clients, and our average revenue per client has gone up from about \$ 1 million in FY-99 to \$2.38 million in the last 12 months. Similarly, we have been able to grow a number of \$5 million clients from 6 to 41. And also because we believe in long-term relationships today, 65% of our revenues come from customers who have been with us for more than three years. And I think this ability of having these kind of client relationships and broadening the services that we sell to them, making sure that we have repeat business from them, has been a very critical part of the Infosys strategy which distinguishes us from many of our competitors here. For example, in the financial services alone, we have 37% of our revenues coming from the world leaders and notwithstanding what we read in the newspapers, clients like ABN Amro are very much client of ours for whom we do work not only in our banking area but also for their activities in Bank in the US. So, I think attracting clients, retaining them, and growing the client business has been a very important part of what we have done. I think we have also managed to focus on using the GDM, leveraging the work across time zones, and capitalizing on the distance, and all this has resulted in for example last year we had growth of 39% as compared to most of the other leading firms who were in the 20% range. So I think the results have spoken for themselves whether it is in terms of client additions, whether it is in terms of the kind of customers we have, whether it is in terms of the growth rates we have, and in terms of the profits that we have. I think on every dimension, the Infosys model has shown a difference and has proved itself on results.

Now going forward I think there are two dimensions to what we are doing. One is the operational efficiency of which Kris will talk a little more when he talks about it, but I think we have focussed in the last several years on improving on our operating efficiency and making sure that in spite of declining prices, in spite of the challenges of the market, we continue to be profitable. For example, we have worked a lot in improving things like our offshore percentage utilization and last quarter alone as you know we increased our offshore percentage by 1.9% and we have also focussed on improving our capacity utilization, and utilization last quarter went up from 82.1% to 83.9%. And we have done many other things in terms of efficiency and utilization and improving the productivity of what we do. Now, this alone is not enough, because while we can get operating efficiencies, we have shown that in every dimension of the business, it is also important to make sure that we are able to differentiate ourselves going forward. And the differentiation is required not so much in terms of the model because our model is a proven model, but in terms of the specific solutions that we can offer. And here again I think we have done many things a lot of which we will discuss in greater detail during the course of the day. For example - verticalization. We have created vertical IBUs or business units and one example of that will be discussed this afternoon, which is the retail business unit, which is really focussing only on retail customers, and therefore verticalization and creating a common set of people



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who deal with one industry and therefore have the kind of consulting and domain expertise required in that industry is a very important part of the differentiation that we are trying to do.

The second thing is that we are not standing still on the global delivery model. In the global delivery model, while there are a lot of benefits and a lot of things that we have honed in the last 20 years, we believe that we cannot afford to stand still and we need to keep improving it even further by bringing in better efficiencies, by defining services better, by adding new services, by leveraging economies of scale, and other things like that, and again one of the presentation this afternoon by Mohan Shekar will talk about how we intend to take the global delivery model even further, and this is an important strategic issue because when somebody is trying to copy your model, if you take your model already from the advanced stage that it is in to even further, that further increases the amount of direction that they have to navigate to come to where you are. So I think while on the one hand we are verticalizing, I think on the other hand we are looking at also increasing and improving the capacity of the model.

The third thing is a big effort in terms of how do we deal with the clients, how do we deal with the relationships, and we are doing a lot of work here in terms of process improvement to make sure that whether it is an account manager, whether it is a consultant, whether it is a delivery person, all these people are working through a one common process to make sure that the customer gets the full benefit of what they want, and we continue to maintain the high-level relationships and make sure that we continue to get repeat business.

The next is investment in sales and marketing. As you know, we spend about 7.4% of revenue on sales and marketing and we have about 275 people out there in sales and marketing. This is an investment which we have been doing now for many years and therefore I think our investment on the ground in sales and marketing is directly responsible for the kind of clients that we have, as I said over 345 clients. The other important dimension of the differentiation that we are doing is on branding. Again Infosys has led on the branding side. We have created a brand, which we believe is unique. This brand has been reinforced with the kind of global attention that we have got, this brand has been reinforced with the Wharton Infosys Business Transformation Award, which is a unique award which has placed us along with the top business school like Wharton in the area of business transformation. We have been the pioneers in customers meetings. Our customer meetings now are almost a decade old where we have this gathering called Milan where we bring all our customers together. Now we have had this event in Europe, in Asia, and in America, and this again is a very strong part of our brand building efforts. So, I think brand building continues to be a big focus for us and will be differentiating us from everybody else.

And then the focus is on solutions to make sure that we have the right kind of solutions. New services, for example, when we talk about retail, we talk about how we are coming out with specific solutions in retailing for lead-time optimization and as I mentioned earlier, our revenues from these new services have already gone up from 10% to 35% in the last five years, and that shows that our policy of bringing in the new services and adding new services and adding and increasing their share of revenue has been successful.

So, I think, broadly then what we have is the following: #1, offshoring - global delivery model is mainstream that there is uncontroversial evidence to that effect and every major company is looking at that. This is becoming mainstream by a combination of market forces and the maturity of firms like Infosys. #2, The incumbent players in the market are not coming to offshore by choice. It is not because they suddenly fell in love with the idea, they are coming to the offshore model because the customers are demanding it. To that extent the battle for IT services is now being blocked to that arena where we are strong, which is in the global delivery model. #3, we think it's the incumbents will have tremendous challenges if they are going to be disruptive to their business model, to their cost structure, to the organizing structure, to their incentive structure, to the turf issues, which will require significant overhauling to really get the value of what we have to offer, whereas in our case we think we have a very lean integrated business model on which we can only add new capabilities. So I think, global delivery model is mainstream, it is being driven by the customers, and we have an



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inherent advantage over the incumbents. And within that Infosys is really in a position of strength because we are the company of choice in this whole transformation, we are seen as a leading IT player. Recently when we went on the ADR road show, I think everybody was able to understand the significance and the consequences of our business model. It is reflected in our growth rates, as I mentioned we went from \$121 million in revenue in FY-99 to something like \$982 million estimated revenue this year and net income from \$30 million in '99 to something like \$238 million to \$239 million this year. So, clearly the model has been proven and it is there in the results.

I think it is reflected in the quality of the client relationships and I really would like you to spend some time thinking about the quality of client relationship that we have. The 345 clients, these are very very strategic clients, and we don't have as you know undue dependence on any one customer, largest customer being about 5.5% or 5.6% of revenue, and therefore this broad range of customers that we have is a very important reason for us to be able to grow at 39% when other companies are growing at much lesser rates. So, I think we have a situation where there is a trend towards offshoring, there is going to be global competition, and I think the challenges are there, and there are other challenges on the horizon. I mean, we are facing challenges to do with the economic environment, we are facing challenges with respect to the whole backlash against outsourcing and visas and we will talk a little more about that a little later, but fundamentally the secular trend is towards the model that we have and in the model that we have, we think that Infosys with its brand, its size, its services, its focus on solutions, its focus on coming out with vertical units, its focus on being able to use or take the GDM model to the next level is uniquely placed to take full advantage of this coming trend, and we do hope that we will do everything that we can to take full advantage of this. Thank you.

We can take some questions now and again we have a full session later on when the entire board is going to meet with the analysts, so we can do it either way.

Male Participant: Yeah, you discussed in quite a bit detail as to what problems your global competition will suffer as they move offshore, but the competition really need not be successful to be disruptive to your business. So, may be they will never hit the operating margins of 27%, may be they will do business at 4% or 5%, and still impact you in terms of let us say hiking employee cost.

Nandan Nilekani: Well I think, arguing that the employee cost challenge is going to be in India and in fact one of the things we did last quarter, as you are aware, is that we actually were able to by expenditure management optimization, able to save money. For example, just in the area of subcontractors we were able to reduce our subcontractor cost by about \$2.2 million which has given us a net saving of about \$500,000, and there are the other benefits we got on utilization and moving things offshore, and we had actually put the savings back in increasing our Indian salaries, our total salary it has been actually has gone up by 1.5% and on an average our Indian salaries though it is variable, but at 100% pay out has gone up about 15%. So, we are aware of the short-term challenges that we would face, we believe that there are really three short-term challenges that we have to contend with, one is, salary increases in India, and I think we have accomplished some of that by raising it by over 15%. We have also done another important thing which is we have made it variable compensation, and the variability is such that if somebody has to be given an offer, the offer has to be more than the highest possible opportunity to earn the person has, which obviously raises the bar even further. So the combination of raising salaries as well as increasing the variable component I think creates some barriers there. So that is one area where we are acutely aware of the challenges and we will continue to focus on making it very attractive for our employees to work in Infosys.

The second possible area is that in terms of the noise, you know in terms of the market place where I think there is a lot of noise being made about offshoring and the risk thereof, and some of this noise is definitely coming from these incumbents, but I think increasingly customers are able to dwell through the noise and are realizing the value, so I think that is something which we should be able to contend with in the minds of the customers.

The third short-term thing that could happen is a suicidal pricing behavior by incumbents to keep us out of customers. Again, there have been some attempts at that, but by and large we find that



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customers are still very much coming to us and in fact when they are looking at offshore they are looking more at working with the top Indian firms rather than with the incumbents. So there will be some pressure on the cost side and in fact if you see our guidance for this year, we have actually assumed that we will on the business side have a pricing decline of 1% a quarter every quarter on revenue productivity, and our net margins we have said will decline for the year from 26% last year to 24.3% this year. So our earning guidance, our revenue guidance factors in these kind of pressures, but we believe we can still very much continue to be very profitable business and we think these are short-term challenges, they are fundamental business model issues that are going to be faced. And our jobs is to deal with these challenges, continue our efforts on verticalization, continue our efforts on solutions, improve our efficiency, and that is the way that we will continued to go ahead. And I think beyond a point, it will be more and more difficult for incumbents to keep raising their cost here and offering lower prices. The other point is that we believe that even if there is a 1% decline every quarter, you know offshore rates may comedown by a couple of dollars, but the bigger advantage we have is when we go out and sell, we can sell services for example in enterprise applications etc., at may be \$75-80 an hour where they are selling at \$125-130 an hour or more, and therefore we think that the bigger threat will be us lowering the prices of onsite enterprise services to them than them lowering the prices of offshore services to us.

Male Participant: One small followup question. See you discussed about how the incumbents are not ready with the global delivery model, but what is your best estimate in terms of the lead time that you have got, by when they would have a comparable delivery capability.

Nandan Nilekani: I think it is not just a question of delivery capability because it is a question of the impact on their balance sheets. As I said, their average revenue per employee is about \$175,000, ours is about \$79,000. So, every man-year that they move offshore, the revenues will decline by that factor. Second, the issue is their sales and marketing cost. Our sales and marketing cost is about 7.4% of revenue. Their sales and marketing cost is about 15% of revenue. So they have the challenge of re-calibrating the sales and marketing cost to a lower percentage of revenue on lower revenue, so that is also very disruptive. So I think there is a model issue that we have to consider here. It is not just about hiring a few people here. The model itself is going to be jeopardized and that we think is really the long-term play.

Narayana Murthy:collaborative distributed software development model. As Nandan pointed out, it is not just hiring a building, it is not just recruiting a few people, it is a complex thing. So while we deliberately do not want to say how many years our competitors will take to catch up with us because that is not fair. Let me tell you our own data that is we have put in 15 years, every year we are improving it and we are bringing new tools, new methodologies, so I would say it is not an easy issue for somebody to overtake. The other question, you have asked about, you know, they will come down to margins of 4 or 5%. Look at the issue today. Just to take an example, a very well known large competitor of ours from the US, domestic company there, has a contribution of approximately \$17,000 per employee at the bottom line level, and that company has 70,000 people or so. And in Infosys today, the contribution is \$15,600. Now remember that 70% of our value addition is from India, which means that we can strengthen our processes, our methodologies, our people, etc., because that \$15,600 which almost the same level, you know probably 10% less than \$17,000, we have lot more strength in terms of making the company stronger. On the other hand if they want to go down further, there are two reasons. One is that contribution will go down with the result they will not be in a position to invest heavily. #2, remember that their G&A cost is primarily out there in the United States and that is not going to go down because they are going to move some people here. All that will happen is, they will go into losses, and the day a company goes into losses, you people know better than I do. It is not going to be easy. So I think it is very complex, it is not an easy issue for somebody to come and (snap) say we will take over.

Nandan Nilekani: Also I think as Mr. Murthy was mentioning, you have to look at the internal disruption that is going to happen, because historically these organizations have worked as local players where they use local resources to deliver value and the whole incentives structure, the bonus structure, the partner structure is based on that. Now suddenly you are saying you are going to



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change the whole model, you're going to use the minimum number of people in the country where you operate, you leverage this offshore capability. How do you divide up the turf issues, the power issues, the incentive issues, they are whole host of things. In fact one of the challenges they're having is they have actually positioning their offshore as low-value activity, because they want to protect the jobs onsite and they are competing with us, so projecting onsite as a high value activity. So there are fundamental disruptive and contradictory things in the way that it is done. And I think this is a classic case of how incumbent behavior is when they are faced with a new business model. You know, first you deny it exists, then you discourage it by saying it is some new low cost stuff, and then you reluctantly accept it is there, and then you embrace it in a half-hearted fashion. That is not the way it is going to be because at the end of the day in any business, whether it is you know Intel-based PCs and computers took over the server market, the way that software industry got verticalized, when you have a superior business model overtime the superior business model is going to win, that is the law of business nature and that is something which is invariably going to happen. There will be short-term challenges as you mentioned, there will be some disruptions that they will try to do, but at the end of the day the superior business model is going to win.

Male Participant: Don't you think that IT industry can move to ROI based pricing? Which means that even tomorrow, say the demand supply situation in the global market improves in favor of demand, a customer will say that the whole pricing has to be done say you cannot earn more than 20% of your capital employed on my business.

Nandan Nilekani: Well, I think it is for us to create profits, it is for us to deliver value. I think when we sell, we have to ensure that whatever at the price that we sell we make a decent profit and the customer gets value for his money. I do not think it is going to be question of him looking at our ROI, it is our ability to be able to create value and that is what we are focussing on. So I do not think the customer is looking at, customer will look at relative prices. If we are able to deliver with internal efficiency and solutions at relative prices and still make profit, then that is the way it is going to be.

Narayana Murthy: Our challenge is really to ensure that a customer perceives, our customer experiences better value for money. In fact that is how all great corporations work, they do not work by just simply reducing prices. So our challenge is very clear, that is how do we make sure that our customers experience better value for money even while paying premium prices, and I do not know of any industry, probably you would know better than I do, where peoples say no I would not give you more because your return on capital employed is this much or something like. It never happens like that. The challenge is to give better value for money.

Nandan Nilekani: And I think what we have to realize is that we have the organization, that our focus and will come out with some of those things in the course of the day, I think our focus on getting a performance work ethic, or focus on creating variable compensations linked to company, unit and persons individual performance, our focus on taking the GDM to the next level. So we are not standing still. There are all things that we are doing to make the model better, more efficient, and we have taken all the decisions and implemented them while all this was going on. So I think in terms of our model being geared up to deal with these challenges, I think it is in better shape than ever before. So now the focus is really to make sure that our approach on solutions and GDM Plus, our verticalization, and all those things happen the way that we want, and we are absolutely confident that the business model is much more robust and is going to win in the end, it is just for us to navigate through these challenges and make it happen, and the very fact that we are standing up here and committing that this year we will have revenues close to a billion dollars, \$966 million to \$982 million, \$239 million in profits, we are standing up and saying that, I think that shows the measure of the confidence we have in what we are doing.

Okay, thank you.