Infosys Technologies Limited

2005 ANALYST MEET

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Good morning, ladies and gentlemen. In the next few minutes, I'll take you through the financial update of Infosys. We will talk about the challenges and how we are trying to manage those. This is the standard safe harbor clause. Anything we talk about the future, please read SEC filings and come to your own conclusions.

The second quarter has been extremely good. We have seen the revenue growing by around 10% sequentially, net income grew by 13%. The growth has mainly come from the financial services sector, especially in the North American area. We increased our guidance based on the growth we saw in the first two quarters. We increased our guidance for the year from 28 to 30% growth in revenue to something around 34%. We increase for guidance for employee addition gross to 20,2000 employees from 12,600 employees and we also increased the Capex guidance from $ 220 to $250 million to something around $ 260 to $290 million.

So what you are seeing here is fundamentally we have a competitive business model. We are like the Dell of the software industry, we are like the Toyota of the software industry. We have a Global Delivery Model which has got a robust training engine, which has got a robust hiring engine. We have invested a lot of money into systems, processes and quality. It's not about hiring some thousand people, 10,000 people in India. It's more than that. So on top of this, we keep adding the services and whatever we do, we leverage our Global Delivery Model. That means 65-70% of the effort happens from India and is a win-win for both customer and us.

And this Global Delivery Model is supported by a highly evolved cost structure. If you look at the numbers from Fiscal 03 to now, the margins have moved in a narrow band. So in spite of lot of pressure on the cost side, in terms of rate increases in terms of currency movement etc etc, we are able to maintain the margins because we have certain levers on the cost side and we are liberating the Global Delivery Model.

We are balancing growth and margins. We don't want to look at one in the absence of other. We want to grow fast but at the same time we want to ensure that we get better margins. A lot of challenges from the margin front, I listed them all down here. I'll talk about each one of them. But we also have certain levers on the cost side, like the onsite-offshore mix, utilization, the scale benefit which we effectively use to offset any impact due to these challenges from the margin front.

The billing rates are stable. Today we are seeing a stable billing environment. Some of the new customers are coming at higher billing rates. Some of the existing customers where the contracts are coming for renegotiation, we have seen some uptick on the price. But overall, we are seeing they are stable billing rate kind of scenario today. If you look at the billing rates, if we take 99 as the base, the billing rates have moved up in fiscal 2000 and 2001. That is mainly on the back of a lot of spending during the dotcom area. But afterwards billing rates corrected because of that. Otherwise, the billing rate is almost constant from what it was in '99 to what it is now.

The new services are the engines of our growth. All these new services, the billing rates are higher than the company average. So when we add new services and they're growing faster, that'll act as a buffer on the overall blended per capita revenue. If you look at the package implementation, it has grown from 11% in September '03 to somewhere around 16% in the last quarter. So overall, the new services, 30% of our revenue in fiscal 03, now this is 42% (ph) of our revenue. So it acts as a buffer on the blended per capita revenue.

The volume growth has been strong. Today the only trend that you see in the IT services market is offshoring. As Nandan said, all CIOs in the planet know about Infosys, know about offshoring. We have seen tremendous growth in volume as we leverage more and more of our Global Delivery Model.

The wage pressure is manageable. India is a large country. India produces something around 400,000 engineering graduates each year. Actually there's 2 million graduates. What we are seeing is that pressure is more on the laterals, that is senior project manager, project manager level, than the freshers. Our gross addition during the last quarter was 6,868 employees. So we are seeing on the offshore side that salaries are going up by 10 to 15% each year. Around 11% of our revenue goes toward paying salaries in India. If that That is growing at 10 to 15%, it'll have impact of something around 150 to 180 basis points on the margin. And our onsite salaries for people outside India, that is growing at 3% which will have impact of something around 90 basis points on the margins. So overall, we have to manage around 250, 260 basis points on the margin due to this rate increase. We do it in -- we try to offset that with some other levers we have on the cost side. Also, if you look at our compensation structure, 30% of the salaries in India across the company is variable, which is linked to company's performance in terms of top line and bottom line and also certain part of individual performance. So we have some buffer there.

Also, our attrition rates are the lowest in the industry, around 10% last quarter. And most of attrition is because of the low performers, 48% due to the low performers leaving the company. So the attrition rates are not at alarming rate for us to worry about the wage increase. So overall, what we are seeing today is even though the wages in India is growing at 10 to 15%, we'll be able to manage that pressure by using some of the levers.

The next important factor is the currency rate. As you know, our functional currency is The Indian rupees, but we do report in dollars. Around 2 to 3% of our revenues comes from India. Rest of it comes from outside India. So we have a major impact if the rupee changes against the dollar. We have two kinds of impact. One is a transaction, the other is translation. Transaction arises because we enter into a contract today, but the transaction gets concluded at a later point of time. Translation is more because we carry lot of foreign currency assets in the balance sheet, which has to be marked-to-market at the end of each quarter. So we have two types of risks, one is a translation risk and a transaction risk.

If we look at our billing rates, 79% of the billing happens in dollars. Around 4% happens in Euros, around 8% happens in GBP and the rest in other currencies. We have seen the rupee and the other currencies moving more widely in the last few quarters. Last quarter the rupee has been stable, but the dollar has depreciated against the Euro and the GBP. This quarter, we are seeing rupee depreciating against the dollar and the dollar strengthening against Euro and GBP. So all this movements will have a impact on our margins. For every 1% change in rupee dollar rates, it will have 50 basis point impact on our operating margin. So we try to reduce the impact by taking forward covers by taking options. We had a forward cover position of $305 million at the end of last quarter. So we try to manage and minimize the impact due to this. We always take a view for the next three to six months. We don't take a very long-term view because it is very difficult to do. So we try to hedge our dollar receivables for next three to six months and manage that. We don't speculate. We trade only, we take only hedging position.

This is more of a detail on how the currencies move. Even though the Euro and the GBP is a smaller part of our portfolio, but any large movement in that will have an impact. So what you see on the non-operating side in terms of translation, that's combination of all this put together.

While we are growing, we make sure that we invest for the future. We have a lot of initiatives going. We have a China initiative where we are expanding rapidly. We have a consulting initiative. We have a product called Finacle. We have put a lot of money in that. We have IBU business plans, where each IBU comes with a three-year plan that they want to make investments. We do that. In the last few quarters, we have made substantial investment in the new plans.

Our effective tax rate is between 13 to 13.5%. We have a scheme in India called Software Technology Park Scheme which gave us a tax holiday for 10 years. This ends in fiscal 2009. The majority of our unit will get out of this tax holiday in 2009, the end of 2009. A few of the units will get out in 2007. So if the tax holiday ends, our effective tax rate may go up, but there is also another scheme which has been notified recently by the government of India. It's called Special Economic Zone scheme. It gives us a 15 year tax holiday; first five years 100%, next five years 50% and the next five years to the extent of reinvestment in the business.

So all the incremental growth from now on, we are trying to get into the new scheme, the SEZ scheme. But it will be very difficult to say what proportion of our revenue will be in STP and what proportion of the revenue will be in SEZ in 2009. Very difficult to say what will be the impact of that. But what we are trying to say is the incremental growth can come under the new scheme, the existing tax holiday ends in 2009. So we have some breathing space till 2009.

Also the government has recently notified a new tax called Fringe Benefit Tax. It is mostly related to indirect benefits given to employees. But the impact of that on our financials is very, very minimal. It's not material.

ESOP charge - we had a new standard, 123R. It is applicable to us from fiscal '07 because we are a foreign filer. We had three schemes running in the company, the '94 plan has lapsed. There are another two, '98 and '99 plans. We stopped granting further options under the plan because we want to see how the accounting regulations change. We are not going to issue any further grants under those schemes. Progeon, our subsidiary continues to issue options but that is not a material amount. So overall, the impact due to adopting this new standard on our financials is not material. It will be around $ 4 million in fiscal '07 and $ 1 million in fiscal '08.

As said earlier, we are leveraging our Global Delivery Model. As long as we do 65 to 70% of the work in India, we are OK on the margin side because when we do work in India, the gross margin is something around 70 to 75%.

When you do it onsite, outside India, it'll be around 30, 35%. So if we're able to improve the mix towards offshore, that'll give us some buffer on the margin side.

Utilization – Any 1% change in the utilization will impact us 50 basis points on the margin. So this is one area where we can improve the efficiency and try to offset some of the impact we have on the financials. We also get the scale benefit on the SG&A. Whatever work we do on the G&A side, we leverage the offshore. We actually do whatever -- we are pleasing to our customers. For example, if you take the total SG&A employees; it was 9.8% of the total manpower of Infosys in fiscal '03. Today it is 6.6%. So we try to get a scale benefit on the SG&A side by not growing them in proportion to their revenue growth.

So the net result of all this is, we have a competitive cost structure which is scalable and if you look at the margins, it has moved in a narrow band. So what it effectively means is even though we have certain impact on the margin side due to all the issues I raised, we also have certain levers on the cost side which we can effectively use to make sure that we meet the margin requirements.

If you look at the balance sheet, we have $87 million of cash and cash equivalents. Our trade receivables is $304 million. So out of our balance sheet size of $1.7 billion, 70% is in cash and receivables. Our balance sheet is strong and liquid. We don't have debt and we make sure that we remain highly liquid because we are in an industry which is changing very fast.

We have very clear policy on returns on dividends. Our cost of capital is something around 14%. Our target return is two times cost of capital for Return on Capital Employed and three times cost of capital for Return on Invested Capital, which excludes cash. If you look at fiscal '05, we have our returns about 3.8 times of cost of capital and return on invested capital of 9.1 time of cost of capital. So we make sure that we earn higher superior returns, even though we maintain cash for strategic reasons.

Our Account receivable days – target is 60 days. Last year it went to 67 days because one customer paid up late. Otherwise, it is between 58 to 60 days. It is in a comfortable position.

So overall, our cash and cash equivalents as a percent of total assets is 54%, as a percentage of revenues 41%. We want to have cash in the balance sheet for strategic reasons. We want to be comfortable at any point of time. We want to have next one year's expense as cash. It gives a lot of comfort in the business.

Our dividend policy is to pay up to 20% of the net profit as dividend. We have been consistently doing that. Last year it was at 18.4%. Whenever we feel that there is excess cash, we don't mind returning it to the shareholder. We have done that in fiscal '04 when we announced a one-time dividend of $164 million.

So finally, we keep our business model very simple. We have no off balance sheet items. We don't have any Special Purpose Vehicles. We provide for all known losses. So what you see is what you get.

So in summary, we are financially strong and profitable company and growing much faster. We have a highly liquid balance sheet and we are able to maintain the margins in spite of significant pressure from a lot of issues like wages, currency and other stuff. So overall, what you see is what you get and we don't have any off balance sheet items which we need to worry. Thank you.