Infosys

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Glenn Greene

My name is Glenn Greene. I am the IT Services Analyst with Oppenheimer. Happy to have Infosys with us today. We have S.D. Shibulal, CEO and MD of the company. The format is going to be a fireside chat-type format and then with 5-10 minutes to go, we'll certainly open it up for questions.

Thank you very much for joining us, really appreciate it. Obviously an interesting time for Infosys. A lot of topics to cover. I think we'll start with the demand environment, what you're seeing on the demand side. It felt to me like the industry across the board during the quarter saw a positive inflection in terms of demand trends. Maybe you could sort of talk about and articulate what you're seeing, maybe contrast a little bit across the verticals.

S.D. Shibulal

The demand environment is slightly different in each of the verticals. If you look at financial services, we are seeing positive momentum in the demand environment, that is across both the US and Europe, in the last two or three months. It is important to know that in financial services, we have seen the demand go start and stop. But at least right now, for the last two or three months, we are seeing a stable to positive trend in the financial services. Financial services is a very large part of our business, app 34% of our business, so that is pretty good for us.

Retail has been doing well for us all along, that continues. Manufacturing is at average, so that continues to be at average. Energy, utilities & telecom has been growing below average for the last two quarters and I think that will continue predominately because of the overhang from the wireline business we have.

Glenn Greene

Maybe more specifically in terms of discretionary spending, again, a lot of the industries seem to sort of be suggesting somewhat of a pick-up in discretionary spending. You seem somewhat hesitant to sort of say we've turned the corner.

S.D. Shibulal

Yeah. First of all, I think that the definition of discretionary spending seems to be somewhat different across various organizations. I was just talking to someone who told me that in some of their organizations, they include mobility and cloud and things like that as part of discretionary spend which we don't. What we call discretionary spend is pure consulting, system integration and any downstream implementation work, as well as any other downstream work which is associated with that. So our consulting and system integration work today is 34% of our business which I would say is the highest in the Indian IT services space. In this businesses, the average lifespan of a program is about 9 to 18 months, which means that we have to constantly keep filling the bucket.

So it has grown for us over the last many quarters, but at an overall level, I think it is yet to stabilize

Glenn Greene

Okay, so you're kind of not ready to say we've turned the corner in terms of a loosening of decision-making? I think you were about to say something.

S.D. Shibulal

Yes. But we don't include some of those things like cloud and mobility and all that.

Glenn Greene

Yeah, the SMAC stack.

S.D. Shibulal

Yeah.

Glenn Greene

Okay. And then how about in terms of the large deal activity? It does seem reasonably healthy for you in terms of contract value of large deals.

S.D. Shibulal

So if you look at our growth, last year our growth suffered because our business and IT operations space did not grow well. It grew way below our company average while consulting and system integration grew above the company average. We have put a lot of emphasis on large outsourcing deals starting last year. The results only started coming in the second half of last year when we won about $1 billion of TCV in large outsourcing deals. In Q1, we won somewhere between 550 to $600 million TCV. We will continue to focus on large deals. But if you look at the industry reports, I think the number of deals have come down and many of the deals are rebids. This is a problem because first of all, this space is very price-sensitive and rebids are even more price-sensitive. So that impacts our pricing ability. But from a deal pipeline, we are seeing a robust pipeline. Wins over the last three quarters have been pretty good.

Glenn Greene

Are you feeling like it's easier to get deals over the goal line?

S.D. Shibulal

But pricing continues to be under pressure.

Glenn Greene

Maybe just two things related to that. Is there any way to sort of frame directionally how much price pressure you're feeling on rebids?

S.D. Shibulal

So they are definitely coming under our company average, number one. Number two, they are margin dilutive in the beginning. Our focus is to make sure that over the life of the program, we are able to manage it at our average margins.

Glenn Greene

Okay. And then there's been a lot of talk about your business operations and broadly you've suggested it's under some pricing pressure. I feel like there's some misunderstanding in the market. I think there's a subset of your business operations business that's maybe under price pressure, not all of it. It might be helpful, I think, to clarify where you're seeing the pressure, whether it's specific to application maintenance or it's broader than that.

S.D. Shibulal

If you look at our business and IT operations, there are five pieces to it – application maintenance, application development and re-engineering work, infrastructure management, independent validation and business process management. The pricing pressure is actually at the application management and infrastructure management. The other areas are seeing less pricing pressure.

Glenn Greene

Okay, so it's only a sub-component of that 62% of revenue, it's not like that whole business is under pressure?

S.D. Shibulal

Yeah.

Glenn Greene

And you've talked about BFS actually perhaps stabilizing?

S.D. Shibulal

Yes.

Glenn Greene

What's the driver of that? What kind of work are you starting to see there?

S.D. Shibulal

I think there are four parts to it. Number one is, I think there's a pent-up demand, work which has not been done for a while, so that's one. Number two is, there is still focus on cost and that is leading to large opportunities, either outsourcing opportunities or cost takeout opportunities. Then, they are continuing to invest in risk, compliance and other related matters. Last, I am not seeing spend related to new product introduction.

Glenn Greene

Okay. You talked briefly about some of your peers categorize the SMAC stack as discretionary spending – social mobility, analytics, cloud – and I presume that's a decent part of your growth story going forward. Maybe you could talk about that and what kind of momentum you're seeing within those service areas.

S.D. Shibulal

We include that as a part of our products, platform and solutions space, and that's a completely different space for us. There are two parts to that business. One there is a services piece and second is a products and platform piece. In the services piece cloud and mobility, both will grow definitely much higher than average. Last year cloud didn't do well but mobility grew probably about 60-70% last year but on a smaller base. As a portfolio, because we are continuing to invest in products and platforms heavily, last year the margin was -3%. That will continue. That is predominantly because the products and platform space, you have to invest first and then recover later and we're investing heavily into that.

Glenn Greene

Okay. That's probably a good segue into the Infosys 3.0 strategy and where you are in that transition. I presume most of the people in the audience here understand what Infosys 3.0 is, but basically you're targeting—maybe it's better for you to explain it, but you're trying to target a third of your mix from business operations, consulting & systems integrations, and products.

S.D. Shibulal

So actually the centerpiece of Infosys 3.0 is what I call client relevance – increasing relevance to the client. That happens in multiple dimensions. One dimension is the geographical dimension where we want to operate with our clients across the globe. So we have expanded into Latin America, we have opened centers in Mexico, in Brazil, and we have been also expanding in the Continent, in Europe. Our center in the Philippines is expanding. We have a center in China. So things like that. The ability to operate with our clients seamlessly and globally, that's one dimension. Second is the ability to operate with our clients on the revenue side and on the cost side. On the revenue side, we look at consulting and system integration as well as our product and solution space. That is the mobility, the cloud kind of space. The cost side is Business & IT operations space and the platform space, those that how do you take out costs. And we wanted to make sure that we were able to operate on both sides, because predominantly if you look at us ten years back, we were on the cost side and that will always be a cost play. On the revenue side, you have an ability to maintain margins and higher level of productivity. There, we have expanded our consulting and system integration business to 34%. We did the Lodestone acquisition which increased our consulting and system integration footprint in Continental Europe. We are continuing to win very large transformational opportunities. We are also winning large transformational opportunities which are failed in the first round. Last quarter we had 3 such situations and out of that, we got 2 of them, where we were taking over failed programs from other companies, so that's one. On the products and platform space which is a new area that we opened up on the cost side, we have booked about $725 million of TCV. But remember, this is a multi-year booking. It's a very stable business, non-linear in effort base but related to the client's business. That means it's an outcome-based approach, $725 million of booked business but it will realize over a multi-year period. We have 7 platforms in the market. Other than 1 platform, every one of them is multi-tenancy. We have multiple products in the market. We have chosen certain areas of interest. One area for example is 'Retail execution' where we have created a 'TradeEdge' platform. We also have a 'ProcureEdge' platform. We have a set of platforms in that space. The second area of interest is 'consumer experience'. There we have 'CommereEdge' platform, we have 'AssistEdge' platform, we have the 'Consumer Genome' as a product, so we have chosen certain areas.

So we have ability to work on the revenues and on the cost side of our clients' business. Our aspiration is, over a period of time, moving to one third-one third-one third revenues from consulting, outsourcing and products & platforms. That will take some time. Consulting and system integration is 34%, while in Europe we are at 40 percent which is actually above our aspirations. Our business and IT operations continues which is 60 percent of our business. The products and platform will organically grow at a slower pace. At some point, if we do something inorganic, that will move the needle. So at some point we have to do something inorganic to move the needle.

Glenn Greene

So do you have a target timeframe to get close to that third mix?

S.D. Shibulal

Yeah, 5-7 years is the timeframe. We have finished 1.5 years

Glenn Greene

Okay. So presumably you would probably do acquisitions on the product side?

S.D. Shibulal

We are finding out that the price is extremely high. Product doesn’t make sense , platforms make sense but multiples are very high.

Glenn Greene Okay. Are there certain strategic areas that you’re looking for on the platform side?

S.D. Shibulal

So the fill-in areas would be either in retail execution, consumer experience. Those are the kind of areas.

Glenn Greene

Okay. Obviously one of the founders came back, Mr. Murthy, as Executive Chairman. Maybe you could talk about what the interplay has been there with him and is he doing a bottoms-up review of your strategy? How are the two of you working in conjunction as it relates to strategy? Are things changing?

S.D. Shibulal

So actually I think we had an investor call some few days back and I believe he categorically stated that there’s no change in the strategy. So I think he has clearly said that. We have worked together for 32 years. The one thing which he is focused even more than I is to make sure that our BITS business grows faster. If you look at last year, our consulting and system integration grew, products and platform got a lot of traction. Our business and IT operations did not grow as much as it should have and it was much below the industry average, so that is an area of focus for him. There are two parts to it. One is sales effectiveness because we want to win more and the other is delivery effectiveness because it is price sensitive. The way to maintain margin is to drive delivery productivity higher.

Glenn Greene

Okay, so no change in the overall strategy. There are certain parts whether it’s on the sales or delivery execution side, that maybe you’re diving deeper into, okay.

S.D. Shibulal

And the third part is on costs. If you look at our onsite salary costs, it has gone up from 33% to 41% over the last 3 years. There are a number of reasons. Number one is that we give market compensation in the US and other parts of the world. Number two is that because we have staffing challenges, our sub-contracting cost has moved up from 2% to 4%.

Glenn Greene

Different topic, moving on to growth and margin outlook. Maybe there's a near-term margin dynamic, which I think is easy to understand, but the intermediate as well. But on the near-term, probably just for the audience and people listening on the web, my understanding is you've got 300 basis points of margin pressure from wage inflation forthcoming, perhaps some pricing realization pressure on some of the re-pricing, counterbalanced by the rupee depreciation, which provides somewhat of a tailwind, and you've still got the potential to raise utilization from 74% towards 78%-82%. Are those the prevailing near-term factors?

S.D. Shibulal

You covered everything. We have a 300 basis point impact from compensation increase onsite and offshore which is a headwind and some pricing pressures because the large outsourcing deals are price-sensitive. On the tailwind, you have the rupee depreciation which will give us 1.25% benefit, plus utilization which will give us some benefit.

Glenn Greene

And on the utilization, so with 50 basis points of sensitivity per point improvement, correct?

S.D. Shibulal

40 basis points at the operating margin level

Glenn Greene

40 basis points, okay. And what is the sensitivity to volume growth? How do I think about the utilization lifting as volume expands?

S.D. Shibulal

One percent of utilization will give us about 1.2% revenue growth. Volume growth and utilization growth go hand in hand.

Glenn Greene

Perhaps more importantly, as we think out beyond fiscal '14 and we talk about the margin outlook, it might be helpful to think about the moving parts, especially as you get toward your target utilization level.

S.D. Shibulal

From an aspiration perspective there's no change because we have always aspired to have at or above industry average revenue growth and one of the leading margins and that continues to be our aspiration. We have seen the short-term challenges because last year our growth was lower, we gave compensation increases onsite and offshore, our utilization went down. I don't see them as structural changes. I see them as short-term challenges. In a couple of years' time all of this should normalize. I cannot predict what the industry growth will be 3 years from now because there are other factors which will impact the global economy, the macro economy – various other factors. But there is no change in our aspiration. It will be to aspire for at or above industry average growth with one of the leading margins.

Glenn Greene

If we dive into the margin parameters – and you can correct me if I'm wrong – but presumably wage inflation is probably 200 or 300 basis point annual headwind.

S.D. Shibulal

That's right, and it will be about 200-300 basis point headwind. But there are many other levers which can be pulled provided there is growth. The growth is an important lever. There are multiple levers that you can pull to manage margins. For example, our onsite effort ratio is at 32%. If I shift my onsite ratio by 1%, I will get 25-30 basis point margin improvement. Our recruitment has currently slowed down completely. But as we recruit more in the bottom of the pyramid, the average cost will come down. Utilization should be somewhere between 78-82 percent. More consulting and system integration revenue will give us slightly more revenue productivity and slightly higher margins. Products and platform should start picking up and go into from where it is today (which is the investment phase) into a margin accrual phase. That will give me margin benefits. Lodestone is running at low single-digit margin. That should move up. If I look at my subsidiaries; Lodestone, China etc. are all subscale and margin dilutive. They will improve. So there are multiple margins levers which we can pull

Glenn Greene

Assuming industry growth low teens for the next 2-3 years, which I'd call reasonably healthy, do you think your margins are stable to improving from here?

S.D. Shibulal

Short-term we will have some challenges. For the long term I can't make a forward-looking statement but I can tell you what our aspirations are. Our aspiration still is to have one of the leading margins.

Glenn Greene

I'll quickly just open it up to the audience. I have more questions, but if anyone wants to sort of chime in, just raise your hand if you've got any questions out there.

Sumanta:

[Inaudible]

S.D. Shibulal

It's fairly simple to win large outsourcing deals. To grow the business, there are 3 pieces. Number 1 is winning more clients but that applies to both sides – business and IT operations and consulting & system integration. Number 2 is mining existing clients. How do you mine out existing large clients? There again, what happens is that the share of our business in the business and IT operations will be generally larger than the other side. Number three is winning large outsourcing deals. For the last one year we have been focused on winning large outsourcing deals. Some of it is in the public domain. For example the Harley Davidson deal, the Sysco deal. Many others are not. But we have closed about $1 billion TCV in the second half of last year and about $ 550-$ 600 mn TCV in the first quarter of 2014.

Q:

[Inaudible]

S.D. Shibulal

What are we doing differently? I think multiple things. Number 1, we have a group called Strategic Global Sourcing Group which we established some time back, and they focus on deals which are $100 million and above and about a considerable amount of new business. So we have invested more into that. We have recruited more people into that group, number one. Number two, as part of that group you have deal management, transition management, people takeover, infrastructure takeover, all those different aspects are concentrated there. We are going after large infrastructure deals. Harley is a good example where we have taken people as well as hardware but not directly, through a partner in that deal. We have also improved our solutions. We have created multiple multi-tower solutions. For example, we launched a new solution called Infrastructure Validation which is a combination of infrastructure and independent validation. We have built multiple alliances. For example for taking over infrastructure we have built an alliance with NTT. We have just announced a partnership with IP Soft which is an autonomics company through which we can drive efficiency and productivity in certain aspects. So it is about capability, it's about solutions and it's about expanding the addressable space.

Q:

[Inaudible]

S.D. Shibulal

I think the products and platform business will move out of investment phase in FY16possibly. Again, these are forward-looking statements. I'm just sharing our aspirations. The cost takeout will probably give us benefit next year.

Glenn Greene

Back to your comment of aspiring to grow at industry growth rates. I mean you're potentially touching that this year. I think you're at 6%-10% in reported terms, 7%-11% in constant currency given all the things that you are doing like winning large deals and this year industry growth is a little bit higher.

S.D. Shibulal

Again, the industry growth rate is also an apples to oranges comparison because if you look at the industry growth, industry growth includes 20% BPO whereas our BPO business is 8% of overall revenues. While industry's BPO business is growing at 20%, we are also growing at 20%. But the point is their 20% vs. our 8% is growing. Infrastructure business for industry is at 10%, we are at 6%. Consulting and system integration, we are at 34%, the industry is at 20%. So these are all apples and oranges comparison.

Glenn Greene

So you're suggesting there may not be IT _____?

S.D. Shibulal

No, I am not suggesting that.

Glenn Greene

You're stating the facts?

S.D. Shibulal

I am just stating the facts, I am not putting a caveat on my aspiration, I'm just stating the facts.

Glenn Greene

All right, fair enough.

S.D. Shibulal

I interrupted you, you were going to ask me something.

Glenn Greene

The timeframe, depending on how you define what industry growth rates are. Maybe you gain share this year if you outperform expectations and your guidance. Is it realistic with your pipeline of big deals or contracts that you've had and where you're going and potentially some momentum improving for your business, would you get there in '15?

S.D. Shibulal

No, the next year guidance we'll come to when we come to next year.

Glenn Greene

It wasn't a guidance question, it was more about what…

S.D. Shibulal

Our aspiration is to get there soon, but we have seen some volatility over the last 4-5 quarters for whatever reason. We had some internal challenges because we were going through a transformation. We had some leadership changes last year. We were moving from 2.0 to 3.0, so that caused some turbulence. We had some external challenges. We had staffing challenges last year because of visa shortage. We have seen a period of volatility. I keep saying "Please don't take one quarter as a secular trend". We need to see 2-3 quarters before we say, "we are in a stable trajectory"

Glenn Greene

Perhaps a few questions on immigration reform – I'm sure your favorite topic. Maybe you could just, at a broad level, your current thoughts and expectations as it relates to this. What do you foresee as the likely outcome based on what you've seen from the House and the Senate?

S.D. Shibulal

I'm not an expert on those outcomes but I can tell you what we are doing. As you know, the Senate bill has been passed, the House bill will come up for debate in 8 to 12 weeks, based on what I hear. What we have been doing and what personally I have been doing is talking to clients. I have talked with many of our large clients personally, explained the bill, explained the fact that it is an industry phenomena, explained the impact of the bill and explained the worst case impact if the bill is exactly the same as what is in the Senate which I don't believe it will be. We don't know how it will pan out. There's a House bill, then there's a conference committee, so the final state is totally unpredictable. But I have explained to the clients if the Senate bill becomes the law, what will be the impact and the impact is one on costs – visa costs as well as the minimum labor costs. Second is usage. Third is on outplacement displacement. The first two are more manageable than the third. On the second one there is a sunset period and we are well within the trajectory of the sunset. The third one is a matter of concern. I have explained this to many of our clients. I have sought their support in creating a balanced view. We have also looked at the options. We have come up with a list of options like more offshore, local development centers, same time-zone development centers, higher local recruitment. So we have various options which we have explored. We are also doing some pilots with much higher offshore to see how it will work but we have not executed on any of the plans.

Glenn Greene

So you're building contingency plans in the background, wait to see what happens? I think I know the answer, but I'll ask it. Has it in any way impacted decision-making by clients?

S.D. Shibulal

No.

Glenn Greene

Okay. Are you making any proactive changes to your hiring plans as relates to mix and where you're locating employees and where you're hiring from?

S.D. Shibulal

So we have been doing local hiring for a while. Our local hiring over the last many quarters has been predominantly US citizens and green card holders and I think that will continue. We have made adjustments to our hiring plan based on our utilization, business mix and growth rates which we are trying to predict but based on this bill, we have not made adjustments

Glenn Greene

I'll open it up for any other questions, if anyone out there has anything.

Q:

Who are your competitors?

S.D. Shibulal

We have 3 distinct business lines. If you look at the business and IT operations, we predominantly compete with the Indian SIs. I say predominantly because it's not 100 percent of the time but predominantly we compete with the Indian system integrators like TCS, Wipro, Cognizant. If you look at the consulting and system integration space, we predominantly compete with Accenture and IBMs of the world. In Europe we compete with some of the local SIs because that is their sweet spot. If you look at products and platforms, the competition set is evolving. If we go and try to sell our HRO platform, we'll end up competing with ADP. But many of our platforms are in a white space where we're not really competing. We're competing with a change rather than a company. AssistEdge, TradeEdge, CommerceEdge are in white space. In Airtel money, the only competition is a company in Nigeria. So in the products and platform space, the competition is evolving. Cloud and mobility, we compete with everyone. So there are three distinct business lines and three distinct competition sets.

Glenn Greene

I'll squeeze in a question on Europe and Lodestone. Maybe you can contrast them. Europe, ex-Lodestone, seemed somewhat soft in the quarter. Maybe you could talk about what you're seeing specifically in Continental Europe and then talk about Lodestone, which actually seemed to have a lot of momentum this quarter, and maybe talk about that. Is that a tailwind from prior project wins, or what sort of explains the ramp in Lodestone?

S.D. Shibulal

First of all, you should completely forget looking at Lodestone financials because we have completely integrated. Part of Lodestone today is the old part of Infosys. We integrated Lodestone in US into Infosys and hence there is no Lodestone presence in the US anymore. Similarly, we have the consulting part of Infosys business in Europe which got integrated into Lodestone, so there is no more consulting part of Infosys business in Europe. We wanted to make a clean integration with zero overlap. So that changes the revenue profile completely. We should forget about any number as the base number, number one. Number two, the integration is complete. In Q1, we had 7 wins adding up to about $80 million of TCV in the transformation space because of them. I am also seeing them in many of my other clients participating in the consulting and system integration work. The integration is complete and the benefits are starting to show.

Glenn Greene

What are you seeing in terms of core European deal momentum?

S.D. Shibulal

The consulting and system integration in Europe for us is 40% of our business. The global SIs operate at about 45-55 mix, so we are getting closer to the global SIs when it comes to consulting and system integration work in continental Europe. That's substantial. So with Lodestone I think that balance will continue to move towards Consulting & SI. We are starting to see the benefits of that. In Europe also within financial services, we are seeing momentum.

Glenn Greene

I think we're out of time, so we'll stop there. Thank you very much, I really appreciate it.

S.D. Shibulal

Thank you.