

The Week Gone By

Weekly Newsletter

Parag's View 

What Is Value Investing?

Different sources define value investing differently. Some say value investing is the investment philosophy that favors the purchase of stocks that are currently selling at low price-to-book ratios and have high dividend yields. Others say value investing is all about buying stocks with low P/E ratios. You will even sometimes hear that value investing has more to do with the balance sheet than the income statement.

In his 1992 letter to Berkshire Hathaway shareholders, Warren Buffet wrote:

We think the very term "value investing" is redundant. What is "investing" if it is not the act of seeking value at least sufficient to justify the amount paid? Consciously paying more for a stock than its calculated value - in the hope that it can soon be sold for a still-higher price - should be labeled speculation (which is neither illegal, immoral nor - in our view - financially fattening).

Whether appropriate or not, the term "value investing" is widely used. Typically, it connotes the purchase of stocks having attributes such as a low ratio of price to book value, a low price-earnings ratio, or a high dividend yield. Unfortunately, such characteristics, even if they appear in combination, are far from determinative as to whether an investor is indeed buying something for what it is worth and is therefore truly operating on the principle of obtaining value in his investments. Correspondingly, opposite characteristics - a high ratio of price to book value, a high price-earnings ratio, and a low dividend yield - are in no way inconsistent with a "value" purchase.

Buffett's definition of "investing" is the best definition of value investing there is. Value investing is purchasing a stock for less than its calculated value.

What Value Investing Is Not

Value investing is purchasing a stock for less than its calculated value. Surprisingly, this fact alone separates value investing from most other investment philosophies.

True (long-term) growth investors.

They do not concern themselves with the price paid, because they only wish to buy shares in businesses that are truly extraordinary. They believe that the phenomenal growth such businesses will experience over a great many years will allow them to benefit from the wonders of compounding. If the business' value compounds fast enough, and the stock is held long enough, even a seemingly lofty price will eventually be justified.

Some so-called value investors do consider relative prices.

They make decisions based on how the market is valuing other public companies in the same industry and how the market is valuing each rupee of earnings present in all businesses. In other words, they may choose to purchase a stock simply because it appears cheap relative to its peers, or because it is trading at a lower P/E ratio than the general market, even though the P/E ratio may not appear particularly low in absolute or historical terms.

Should such an approach be called value investing? I don't think so. It may be a perfectly valid investment philosophy, but it is a different investment philosophy.

Contrarian investing is sometimes thought of as a value investing sect.

In practice, those who call themselves value investors and those who call themselves contrarian investors tend to buy very similar stocks.

However, in most cases, the line separating the value investor from the contrarian investor is fuzzy at best. Certain contrarian investing strategies are derived from three measures: price to earnings, price to cash flow, and price to book value. These same measures are closely associated with value investing.

Infosys Technologies Limited
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De-rating risk v/s. Earnings risk !

A good 21% increase in PAT for FY08 despite a 11% INR appreciation coupled with sustained operating margins and top it up with a decent ~20% guidance in an expectedly difficult year; the outcome is 17% appreciation in 3 days for our market cheerleader, IT bellwether.

However, its not just about the past performance and the guidance. There are a number of concerns and uncertainties staring in the face for current & potential investors. We share our perspectives on the same.

Growth :

The subdued economic environment in US and a significant exposure to the ailing BFSI segment (36% of total business in FY08) have been pegged to be the key concerns to Infosys' growth prospects in the near term. What adds weight to this is the company's survey across its top 100 clients, wherein 76% of them are expected their IT budgets to be flat or marginally down. Also the likeliness of price increases on new contracts are poor as compared what one would have anticipated sometime back.

However, what is heartening is the management guidance of 19-21% topline growth for the full year. The management has indicated that Infosys has been pursuing a few large deals since the past 3-4 quarters. Such large deals take 6-9 months to close versus 1 month for small deals. Infosys had added one \$300 Mn. client in Q308. We think that the management may have assumed some success rate here, while giving the annual growth guidance for FY09.

Infosys has given a guidance of ~21% Y-Y topline growth & ~15% Y-Y EPS growth for Q1FY09. However, on a Q-Q basis the growth in both topline & PAT would be flat. Our thinking is that for Infosys, growth can be

and should be compared sequentially. Ergo the concern for the back-ended nature of the 19-21% growth guidance is valid & justified.

It is interesting to note that in FY08 Infosys added 33,177 nos of employees and achieved a 20% topline growth. FY09E employee addition plan at 25,000 is decent, but still lower than FY08 addition. With a poor probability of any price increase and also factoring the higher employee base, we wonder how would our favorite company manage the 19-21% growth (almost same as last year) with relatively lower staff addition. The current utilization rates and USD at Rs. 40 also do not seem to be capable of providing much help from the current levels.

Our final conclusion on this account is that the revenue growth guidance by Infosys is aggressive and it would be difficult to maintain its general reputation of beating guidance. De-rating Risk here is strong

Margins :

In FY08 Infosys lived upto to its persona as it was able to maintain its margins in an adverse foreign exchange scenario. But will it do it again in FY09 as well?

We believe that the margin levers on account of pricing, currency, utilization remain limited. Note that the management is expecting the utilization at 77% as against the current 75%. Although lower than previous year, there still are salary hikes of 11-13% for offshore and 4-5% for onsite employees. There is a possible scope of improvement in sales & general expenses. We also feel that there is in reality no case of margin maintenance at the cost of extended credit period (Debtor days increased from typically 60-65 days to 72 days in FY08).

However, one key area of margin expansion could be in the form of increased offshoring as indicated by the top 100 clients in the dip stick survey at the cost of flat/declining overall IT budgets. This point, we feel, does somewhat help settling one important point of contention, whether a US slowdown can be a boom or doom for the Indian IT industry. If we may generalize, except for any severe case, where a BFSI client goes bankrupt, for most other cases, the IT spending may suffer on growth but the component of offshoring may be actually increasing. For FY08, in terms of effort, offshore was 75% and in terms of revenues, it was 75%.

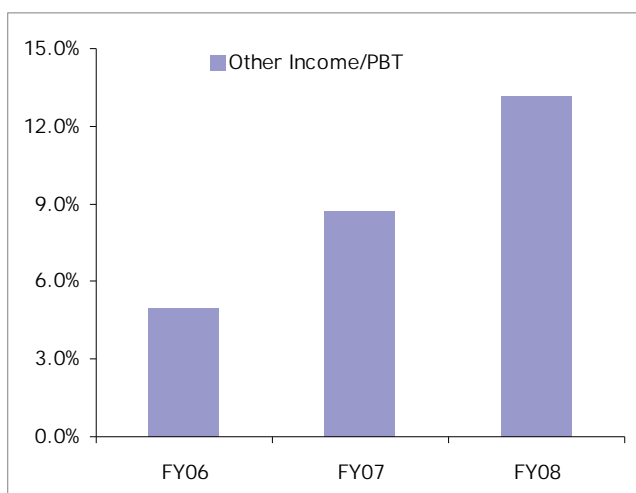
Our conclusion is that operating margin percentage may be maintained. We perceive limited de-rating risk on this account.

Dividend Policy:

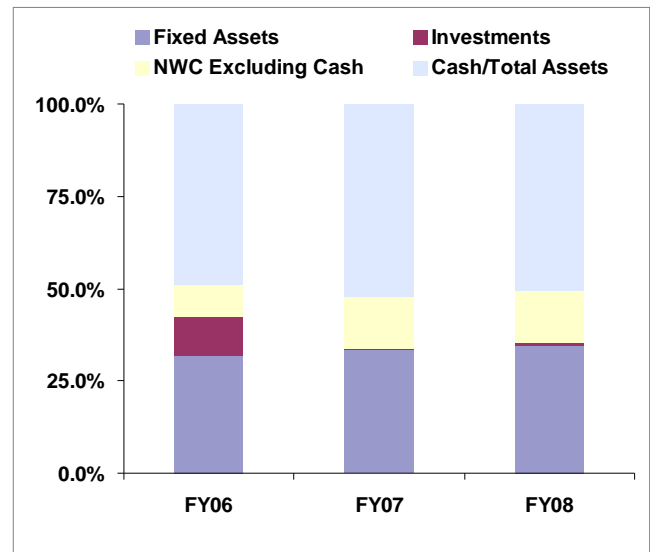
We are heartened by the management's stand to increase the dividend payout ratio from upto 20% to upto 30% going ahead. Key impact of this policy change:

- Surplus cash and income earned on the same would come down. This negatively impacts the EPS and NPM, though marginally. However, the investors are anyways compensated for this in terms of direct dividends. Other income as a percentage of PBT has steadily increased from 5% in FY06 to 8.7% in FY07 and further to 13.2% in FY08.

Other income as % of PBT



- However, this was an important step in the right direction as Cash has been constituting 50% of the total balance sheet size for the past few years.



The incremental cash addition to the balance sheet as a percentage of the operating cash flows was 81% in FY07. This number for FY06 & FY08 stands at 59% and 39% thanks to the exceptional higher dividends provided in both these years.

Overall this higher dividend policy will help in improving the return ratios (which are otherwise likely to moderate on account of higher taxation and therefore lower NPMs) and add to shareholders value.

Taxation :

While the SEZ extensions at Chandigarh & Chennai and the new SEZs coming up at Mysore, Bangalore & Hyderabad, will help on the taxation front, the overall tax rate would nevertheless go up upon withdrawals of tax sops in FY10. The management has guided for tax rate to be in range of 15-16% in FY09 and within 20-22% for FY10. While the tax rate as a % of PBT is increasing sharply, as a % of revenues, the NPM stands impacted by ~130-140 bps on account of the increased taxation.

Foreign Exchange Impact :

The company guidance and our forward calculations are based on the current rate of Rs.

40/\$. Our calculations suggest that Re. 1 change in the USD rate, say from Rs. 40 to Rs. 39 (2.5% change) can bring about a big 8% change in EPS. The risk on this front should not be under-estimated by the investors.

The biggest bone of contention - What P/E to assign??

Infosys saw its profit grow by 21% in FY08, where as its share price corrected by 26% during the same period.

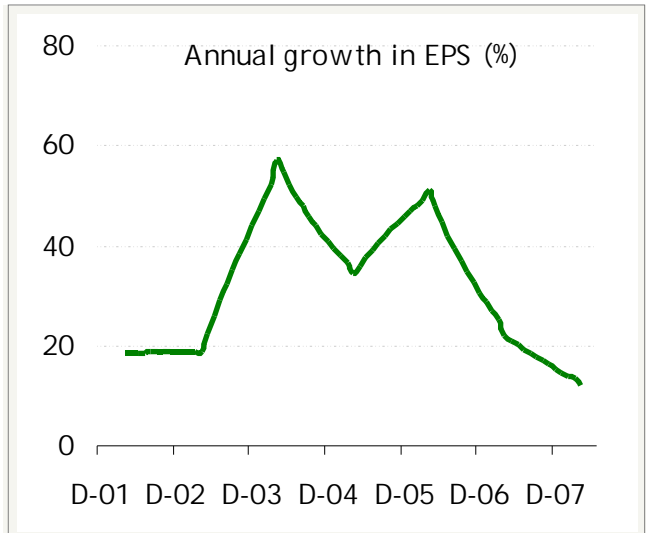
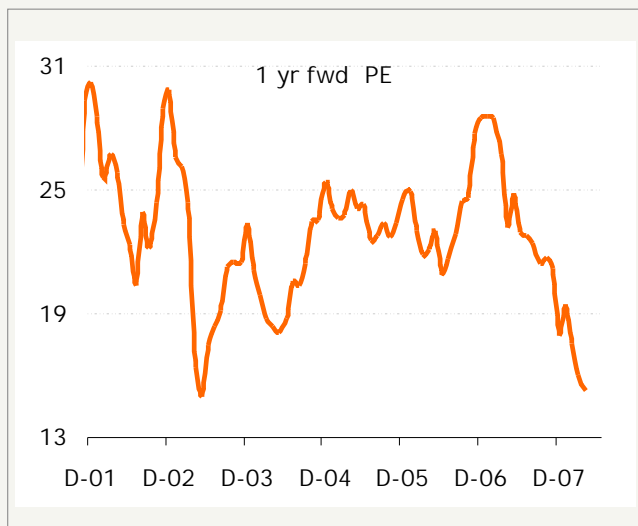
Earnings Growth v/s Market Cap chart



The one year forward P/E band has declined from the high of 30 times to even below 15 times and now stands at 17.8 x at the CMP of Rs. 1660.

Key Observation here :

P/E Band has historically been in alignment/trend with Earnings growth.



Our feeling on the outlook for Infosys' business is that the topline growth may be in 20%-18% but the PAT growth could be like 15%-12% over the next two years. Should this mean that there is scope for further de-rating of the P/E multiple in times to come?

One cannot outrightly rule-out this possibility, given that a negative hit from a sub-prime impacted client and a slightly more adverse currency scenario may even make the above modest growth expectations difficult to achieve.

Despite the above hypothesis, we feel difficult to digest that India's most respected corporation, with business model far superior to most other businesses & industries and ROE's (including cash) still very high at 30% can be so ill treated in terms of valuation multiple, especially when there are so many instances where companies with much inferior business models and return ratios are trading at much higher valuations.

However, the ROEs has consistently remained in the mid 30s percentile, while the P/E multiple has gone through sharp fluctuations, sadly reflecting no correlation between the two.

The Joker in the pack !

The most important thing we perceive the market is missing out is the case of a possible acquisition in either US or EU and the likelihood of the deal materializing at attractive valuation given the

present subdued scenario. Infosys currently has Rs. 6950 Crs of Cash which may increase to Rs. 10,000 Crs in FY09. A profitable acquisition would be a fantastic way to address both growth and arrest in contraction of ROEs due to the ever increasing cash.

On the flipside, it may not be easy for Infosys to get a decent size & well priced acquisition, especially in the developed markets, which would be making even the modest returns that Infosys can earn on its surplus cash. Also it is on Infosys, which has traditionally grown organically on the strength of its immaculate training processes, to demonstrate its apt for making & integrating acquisitions.

Overall Opinion :

We would be glad if the market starts considering for the above joker/ trump card. Until then, our call is that atleast, the de-rating trend may get arrested despite the continuing earnings-growth risk. We are expecting a target price of ~ Rs. 1820 based on 17.5 x FY10E earnings of Rs. 104 per share. (10% Upside Only)

BUY if CMP < Rs. 1520

SELL if CMP > Rs. 1820

Quarterly Financials

Earnings Statement								
YE March (Rs. Mn.)	Q4FY08	Q3FY08	Q-Q(%)	Q4FY07	Y-Y(%)	FY08	FY07	Y-Y(%)
Net Revenues	4,542.0	4,271.0	6.35%	3,772.0	20.41%	16,692.0	13,893.0	20.15%
Direct Expenses	2,482.0	2,325.0	6.75%	2,021.0	22.81%	9,207.0	7,458.0	23.45%
Gross Profit	2,060.0	1,946.0	5.86%	1,751.0	17.65%	7,485.0	6,435.0	16.32%
Selling & Marketing expenses	223.0	205.0	8.78%	268.0	-16.79%	916.0	929.0	-1.40%
General & Admin Expenses	359.0	349.0	2.87%	286.0	25.52%	1,331.0	1,115.0	19.37%
Total Expenditure	3,064.0	2,879.0	6.43%	2,575.0	18.99%	11,454.0	9,502.0	20.54%
Operating Profit	1,478.0	1,392.0	6.18%	1,197.0	23.48%	5,238.0	4,391.0	19.29%
OPM (%)	32.54%	32.59%	-0.16%	31.73%	2.54%	31.38%	31.61%	-0.71%
Other Income	139.0	158.0	-12.03%	120.0	15.83%	704.0	370.0	90.27%
EBITDA	1,617.0	1,550.0	4.32%	1,317.0	22.78%	5,942.0	4,761.0	24.81%
Depreciation	157.0	153.0	2.61%	145.0	8.28%	598.0	514.0	16.34%
EBIT	1,460.0	1,397.0	4.51%	1,172.0	24.57%	5,344.0	4,247.0	25.83%
Interest	0.0	0.0		0.0		0.0	0.0	
PBT	1,460.0	1,397.0	4.51%	1,172.0	24.57%	5,344.0	4,247.0	25.83%
Tax	211.0	166.0	27.11%	27.0	681.48%	685.0	386.0	77.46%
PAT Before MI	1,249.0	1,231.0	1.46%	1,145.0	9.08%	4,659.0	3,861.0	20.67%
Minority Interest	0.0	0.0	0.00%	1.0	-100.00%	0.0	11.0	-100.00%
PAT	1,249.0	1,231.0	1.46%	1,144.0	9.18%	4,659.0	3,850.0	21.01%
EPS	21.8	21.5	1.46%	20.0	9.18%	81.5	67.3	21.01%
Ratio Analysis								
YE March (Rs. Mn.)	Q4FY08	Q3FY08	Q-Q(bps)	Q4FY07	Y-Y(bps)	FY08	FY07	Q-Q(bps)
OPM (%)	32.54%	32.59%	(5.1)	31.73%	80.7	31.38%	31.61%	(22.6)
EBITDA (%)	35.60%	36.29%	(69.0)	34.92%	68.6	35.60%	34.27%	132.9
PBIT (%)	32.14%	32.71%	(56.5)	31.07%	107.3	32.02%	30.57%	144.6
PAT (%)	27.50%	28.82%	(132.3)	30.33%	(283.0)	27.91%	27.71%	20.0
Tax Rate (%)	14.45%	11.88%	256.9	2.30%	1,214.8	12.82%	9.09%	372.9

Data Points

Revenue by Geographical Segment

Particulars (%)	Mar-08	Dec-07	Sep-07	Jun-07	Mar-07	Dec-06	Sep-06
North America	60.7	62.3	62.6	62.6	62.6	63.2	63.7
Europe	29.3	28.6	27.4	26.8	26.6	26.8	25.8
India	1.3	1.2	1.0	1.8	1.5	1.8	1.6
Rest of World	8.7	7.9	9.0	8.8	9.3	8.2	8.9
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Revenue by Industry

Particulars (%)	Mar-08	Dec-07	Sep-07	Jun-07	Mar-07	Dec-06	Sep-06
Transportation	2.8	2.4	2.3	2.3	1.8	2.0	2.7
Telecom	22.5	21.1	20.6	22.0	21.9	18.3	18.9
Services	5.5	6.0	7.7	7.6	7.9	8.3	7.7
Retail	11.9	12.0	12.5	10.8	10.8	10.5	9.0
Manufacturing	16.4	14.6	13.9	13.6	12.9	12.8	14.0
Insurance banking & financial	33.9	36.8	36.5	36.1	37.0	38.6	37.4
Energy & Utilities	5.2	5.2	5.3	4.9	4.8	5.4	5.6
Others	1.8	1.9	1.2	2.7	2.9	4.1	4.7
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Employee Metrics

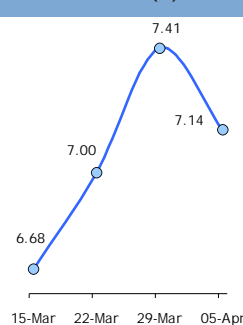
Particulars	Mar-08	Dec-07	Sep-07	Jun-07	Mar-07	Dec-06	Sep-06
Total Employee	91,187	88,601	80,501	75,971	72,241	69,432	66,150
Net Addition	2,586	8,100	4,530	3,730	2,809	3,282	7,741
Q-Q growth	2.92%	10.06%	5.96%	5.16%	4.05%	4.96%	13.25%
Y-Y growth	26.23%	27.61%	21.69%	30.07%	37.04%	40.49%	43.19%

Revenue by Project Type Excluding Products

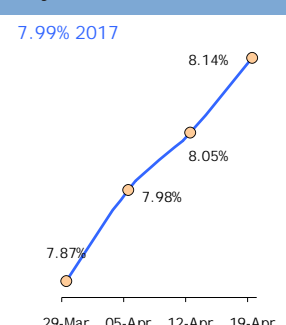
Particulars (%)	Mar-08	Dec-07	Sep-07	Jun-07	Mar-07	Dec-06	Sep-06
Fixed Price	33.2	32.8	29.8	27.5	25.9	27.7	26.2
Time & Materials	66.8	67.2	70.2	72.5	74.1	72.3	73.8
Total	100	100	100	100	100	100	100

Local Equity Market						Top Gainers & Losers of the Week			
INDICES	21-Apr-08	Week Ago	% Chng	Month Ago	% Chng	Top Gainers		Apr 21, 08	% Chng
Sensex	16,481.20	15,807.64	4.26	14,994.83	9.91	Elgitread (India) Ltd.	26.10	42.62	
Nifty	4,958.40	4,777.80	3.78	4,573.95	8.41	Chambal Fertilizers & Chemicals Ltd.	70.00	39.17	
CNX Nifty Junior	8,573.35	8,100.05	5.84	7,431.15	15.37	Bombay Dyeing & Manufacturing Co. Ltd.	823.65	36.63	
S&P CNX500	4,027.90	3,861.70	4.30	3,657.80	10.12	I-Flex Solutions Ltd.	1,297.10	27.00	
CNX Midcap 200	6,691.30	6,384.90	4.80	5,847.70	14.43	Nagarjuna Fertilizers & Chemicals Ltd.	46.90	24.90	
CNX IT	4,304.20	3,824.65	12.54	3,501.15	22.94	MindTree Consulting Ltd.	488.30	23.59	
International Equity Market						Top Losers			
INDICES	21-Apr-08	Week Ago	% Chng	Month Ago	% Chng	Balaji Telefilms Ltd.	179.55	(9.80)	
DJIA	12,849.36	12,325.42	4.25	12,361.32	3.95	Zee Entertainment Enterprises Ltd.	215.35	(9.67)	
Nasdaq	2,402.97	2,290.24	4.92	2,258.11	6.42	Ambuja Cements Ltd.	113.10	(7.26)	
S&P 500	1,390.33	1,332.83	4.31	1,329.51	4.57	Max India Ltd.	165.00	(7.17)	
FTSE 100	6,056.50	5,895.50	2.73	5,495.20	10.21	Kohinoor Foods Ltd.	116.35	(6.85)	
Nikkei 225	13,476.45	13,323.73	1.15	12,260.44	9.92	Crest Animation Studios Ltd.	65.50	(5.76)	
Hang Seng	24,197.78	24,667.79	(1.91)	21,108.22	14.64	Bhansali Engineering Polymers Ltd.	18.95	(5.49)	
HSCEI	12,675.43	13,357.12	(5.10)	10,836.20	16.97	Rajesh Exports Ltd.	87.15	(5.22)	
MSCI Indices						Sectoral Performance			
MSCI Indices	21-Apr-08	Week Ago	% Chng	Month Ago	% Chng	Sectors	Week	Month	3 Months
The World Index	1,504.56	1,461.42	2.95	1,406.98	6.94	Fertilisers	17.16	28.86	(21.14)
Emerging Market	1,175.85	1,160.36	1.33	1,052.01	11.77	Tyres	14.02	19.56	(17.49)
EM Asia	459.96	462.33	(0.51)	414.50	10.97	Cables - Telecom	13.18	27.09	(28.91)
EM India	522.26	497.22	5.04	463.69	12.63	Computers - Software	12.83	31.60	(6.48)
Commodities						Telecommunication - Equipment	12.07	20.35	(38.40)
Commodities	21-Apr-08	Week Ago	% Chng	Month Ago	% Chng	Abrasives	11.09	3.96	(25.12)
GOLD (\$/oz)	921.65	924.45	(0.30)	919.50	0.23	Computers - Hardware	10.63	17.61	(21.76)
SILVER (\$/oz)	17.91	17.73	1.02	17.13	4.55	Compressors / Pumps	10.16	17.05	(22.67)
ALUMINIUM (\$/t)	3,075.00	3,045.00	0.99	2,843.00	8.16	Leather And Leather Products	9.43	17.59	(30.83)
COPPER (\$/t)	8,570.00	8,555.00	0.18	7,840.00	9.31	Textiles - Synthetic	9.41	18.92	(34.58)
CRUDE - BRENT (\$/bbl)	113.86	109.58	3.91	100.13	13.71	Pesticides And Agrochemicals	9.08	21.24	(13.16)
CRUDE - WTI (\$/bbl)	116.66	111.76	4.38	101.84	14.55	Chemicals - Speciality	8.93	14.07	(22.58)
Transportation						Power	8.23	15.11	(24.79)
Commodities	21-Apr-08	Week Ago	% Chng	Month Ago	% Chng	Tea And Coffee	8.14	25.68	(0.35)
World SCALE	130.00	105.00	23.81	122.50	6.12	Textiles - Cotton	8.06	15.79	(26.00)
BALTIC FREIGHT INDEX8,	203.00	7,961.00	3.04	7,684.00	6.75	Petrochemicals	7.96	16.10	(33.03)
Forex						Finance	7.81	16.42	(32.50)
FOREX	21-Apr-08	Week Ago	% Chng	Month Ago	% Chng	Chemicals - Organic	7.23	17.50	(4.58)
USD	39.85	39.98	(0.33)	40.43	(1.43)	Dyes And Pigments	7.15	7.91	(25.44)
GBP	79.61	78.45	1.47	80.33	(0.90)	Textile Products	7.06	14.77	(26.35)
EURO	63.03	63.00	0.05	62.44	0.94				
YEN	38.44	39.44	(2.54)	40.66	(5.46)				
Global Listings									
Scripts	19-Apr-08	Week Chng	Month Chng	Premium/D iscount	Share per ADR/GDR				
Infosys ADR	43.08	17.83	7.91	3.46%	1				
Wipro ADR	12.43	11.58	4.50	7.84%	1				
ICICI Bank ADR	42.18	10.39	6.29	0.43%	2				
Satyam ADR	26.29	16.48	2.59	11.70%	2				
HDFC Bank ADR	105.34	12.57	(0.84)	-0.15%	3				
MTNL ADR	5.28	9.54	(1.63)	-0.29%	2				
Dr. Reddy ADR	15.46	4.81	10.99	1.55%	1				
Reliance GDR	134.50	8.47	20.10	1.50%	2				
ITC GDR	5.34	5.12	9.96	0.63%	1				
Ranbaxy GDR	12.07	8.25	3.15	0.07%	1				
L & T GDR	69.60	1.61	(4.73)	-0.01%	1				

Inflation (%)



10 year G-Sec Bond Yield



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