SELECTIVE
WEALTH MANAGEMENT

Infosys
April 30, 2013

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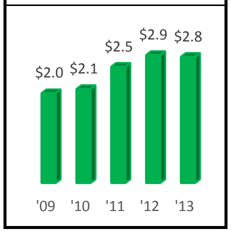
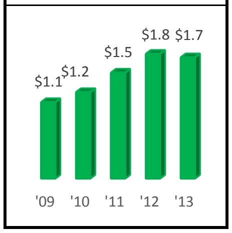
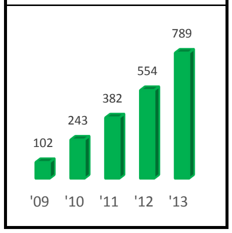
General Overview

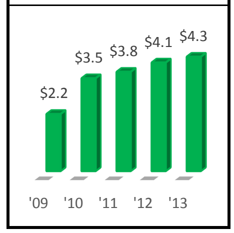
Infosys LTD (INFY) is an India based provider of IT, consulting and business process services. The company was founded with $250 in 1981 by 7 individuals. In the last 32 years Infosys has grown to a $24 billion dollar enterprise with more than 780 clients in countries all over the world.

Revenue	Gross Profit	Owner Earnings	Client Relationships	Balance Sheet
$7,398,000,000	$2,761,000,000	$1,709,660,000	789	Cash = $4.3 Billion
5-Year CAGR = 12.2%	5-Year CAGR = 8.9%	5-Year CAGR = 12.3%	5-Year CAGR = 66.8%	Debt = $0









The company specializes in helping clients build more efficient businesses. INFY employs 150,000 software developers located in countries around the globe that are organized into teams based on geography and work seamlessly around the clock to write software programs and develop business processes to save money for their clients. This global delivery model and high value proposition has allowed INFY to grow rapidly and create tremendous wealth for shareholders.

Purchase Logic

Infosys provides IT, consulting and business process services to more than 798 clients. The economics of a single client relationship are amazing. When Infosys partners with a client they develop a very intimate relationship and tend to monopolize all work with that client going forward. In 2012 98% of INFY's revenue came from repeat business. It is one of the 'stickiest' business models in the world and makes predicting income relatively simple. INFY has been able to compound their earnings every single year at an impressive rate for more than 25 years by simply adding a few new customers each year. This feat has been accomplished with zero debt.

We acquired our stake in INFY at approximately 12.5x earnings with an average purchase price of $40.07 per share. This purchase price compares favorably to the current price multiple of 14x earnings for the average S&P 500 constituent. The rationale behind our purchase was simple - we believe we paid a fair price for an outstanding business. INFY has compounded earnings at a rate of 12.3% for the last five years and has only experienced one year of declining income in the last 30 years. We fully anticipate INFY to resume the long history of growth for the next 10 years – albeit at a relatively slower pace.

Future Expectations

It is our expectation that INFY will compound earnings at a rate of 8% or more for the next 10 years. During this decade of growth we'd expect to see annual results fluctuate between +0% and +25% depending on macroeconomic conditions and the general spending level of INFY's client base. We anticipate the growth to be relatively smooth and continually upward due to the highly stable nature of the industry in which INFY operates. Due to the slightly lower prospects for growth we would be content selling the business in the event the price multiple appreciates to more reasonable levels.

Financial Highlights

Historical Growth

In the last 5 years INFY has managed annual top line growth of 12.2% which has translated into a CAGR of 12.3% for owner earnings. The company has increased owner earnings every year – without the exception of 2013 – since their inception in 1981. Below are most relevant performance measures for the business for the last 5 years:

Table 1: Performance Measures

Year	'09	'10	'11	'12	'13
Total Revenue	$4,663,000,000	$4,804,000,000	$6,041,000,000	$6,994,000,000	$7,398,000,000
Gross Profit	$1,964,000,000	$2,055,000,000	$2,544,000,000	$2,876,000,000	$2,761,000,000
Owner Earnings	$1,076,750,000	$1,218,370,000	$1,493,580,000	$1,759,300,000	$1,709,660,000
YOY Earnings Growth	10.6%	13.2%	22.6%	17.8%	-2.8%
Client Relationships	102	243	382	554	789
Cash	$2,167,000,000	$3,524,000,000	$3,769,000,000	$4,121,000,000	$4,341,000,000
Debt	$0	$0	$0	$0	$0

All trends are favorable with the exception of slight compression in gross profit margins. We anticipate the gross margin level to continue to compress slightly over the years. This issue is addressed in further detail under 'Risks: Wage Increases in India'.

Balance Sheet

INFY has a simple and impressive balance sheet. In the last 10 years the company has operated with no debt and has consistently increased the cash balance. The company maintains a certain amount of cash for liquidity and operational expenses, but we estimate that of the $4.3 billion in cash equivalents held as of December 31, 2012 that approximately $2 billion is excess and available for acquisitions, dividends, or share repurchases.

Future Performance

Our expectations for the future are largely based on the overall conditions of the BPO industry. The annual capital expenditures for IT services continues to expand for enterprises globally and we anticipate INFY to win a fair share of new business during the next 10 years. For that reason we are confident that INFY will be able to compound earnings at a rate of 8% or more for the next 10 years. Below is a detailed discussion of why we believe the necessary contributors for growth, namely favorable industry conditions, will continue into the future.

Favorable Industry Conditions

INFY is one of many third party providers of information technology, consulting, and business process outsourcing (BPO) services. The number of firms competing in this space is large, but the vast majority are extremely profitable. The high profitability of the industry can be attributed to the overall industry having very low capital requirements and the revenue retention rates are typically in excess of 100%. These two factors combined to create an environment for business success.

Low Capital Requirements

The BPO industry is a service industry. The capital requirements to launch a BPO company are low – typically the only expenditures required are office space and computers. Due to small capital outlay expanding a business is limited only by the management team's ability to hire, train, retain, manage, and motivate a competent workforce. INFY has a strong management team that built a world class infrastructure to manage and expand the company's workforce. We expect INFY to be able to reinvest a portion of the company's profits into the expansion of the business at exceptionally high rates of return during the next 10 years. The remainder of profits will likely be sent to shareholders as dividends.

High Revenue Retention Rates

We define the revenue retention rate as the amount of revenue generated by clients in the current year divided by the revenue generated by those same clients in the following year.

Example:

2012: Clients = 100 Revenue Per Client = $100,000 Total 2012 Revenue = $10,000,000

2013: Clients = 98[1] Revenue Per Client = $105,000[2] Total 2013 Revenue = $10,290,000

Revenue Retention Rate = $10,290,000 / $10,000,000 = 102.9%

1. This figure does not include new clients added during the time period. In this example we assume that of the 100 clients the company served during 2013 that two went out of business or left to a competitor. The client retention rate in this case is 98%.
2. The revenue per client increased 5% year over year. The 98 clients that remained in 2013 increased their overall spending with INFY.

The majority of the BPO industry benefits from revenue retention rates in excess of 100%. The outstanding revenue retention rates can be attributed to high switching costs associated with changing a BPO partner. The high switching costs arise from the extreme integration that occurs when a BPO partner, such as INFY, engages a client on a new project. It takes substantial time and energy for the client to communicate their business model, vision, and needs to the BPO partner. This process often requires teams ranging from 10 to 1,000 communicating together across the two organizations. Once the BPO partner is familiar with how a client operates and begins building custom solutions for that client the two operations begin to integrate. The longer the two partners work together the deeper this integration and the more expensive it is to switch to a competing firm. This gives the BPO partner a considerable pricing advantage when bidding for additional projects with existing clients. As clients expand their project spending on software solutions the incumbent BPO partner typically wins the majority of all work moving forward. Companies such as Oracle, SAP, Accenture, IBM, Infosys, Cognizant, and others have benefited greatly from these high switching costs.

In addition to high switching costs the strong value proposition entices clients to continue to increase their annual spending on BPO development projects. The return on investment for the client is extremely high as BPO projects reduce costs and increase revenue. Clients are able to improve operational performance and increase profitability dramatically for every dollar spent on BPO solutions.

Risks

We view INFY as a very low risk investment. All industry participates earn large profits and the nature of the industry protects BPO companies from external competition. INFY will be highly successful in the next 10 years, however, there are a few short-term and long-term risks that could impact the price performance of the stock over short periods of time.

Short-Term Risks

- Reduction in Client Spending. On occasion multiple clients elect to reduce or delay project costs associated with business process development. Historically these reductions or delays are temporary and spending resumes at higher levels once short-term budgeting concerns alleviate. The industry is largely recession proof due to the high value proposition – typically companies continue to cut costs and spend on BPO during difficult times. This was show cased during the 2008 – 2009 financial crisis.
  - Low Risk
- Loss of major customer. As of December 31, 2013 the company provided services to 798 clients. No individual customer exceed 10% of consolidated revenues. The top five customers in 2013 represented a total of 15.5% of revenues. The loss of multiple major customers simultaneously would impact short term results. At the current growth rate it would take approximately 24 to 36 months to replace the revenue lost from the top five customers.
  - Low Risk
- Foreign Exchange Fluctuations between USD and India Rupee. The majority of employees are located in India and are paid in Rupees. The majority of clients are located in North America and Europe and payments made to INFY are denominated in USD or Euros. Should the Indian Rupee materially appreciate against these two currencies it could impact overall profitability due to higher wage costs.
  - Moderate Risk
- Limit on US H-1B Visas. The majority of INFY workforce is from the Asia-Pacific region and requires H-1B visas to perform work for corporations in the United States. This has been a political hot spot for several years and reduction in the number of H-1B visas would temporarily impact INFY business model. The limit on visas would require INFY to hire more employees from North America and increase costs for the business. This would likely be offset by increasing pricing to maintain gross profits margins and not materially impact the business in the long term.
  - Moderate Risk
- Wage Rate Increases in India. The demand for highly skilled technical labor in India continues to increase and the wages for technically competent employees continues to rise. As wages increase it compresses margins for INFY. The trend in wages will likely continue upward and be offset slightly by price increases to clients. This will cause margin compression for the business, but the returns on capital would remain significantly above 20%.
  - Moderate Risk

Long-Term Risks

- Technological Obsolescence. More often than not firms that must rapidly adapt to changing technological trends are at risk to technological obsolescence. The opposite is true for INFY. The firm generates revenue by implementing new technological trends into business processes globally. As technology evolves, from mobile to big data, INFY has a new greenfield opportunities and new projects to engage with existing clients.
  - No Risk

- Political Changes in India. India is currently exceptionally friendly toward software programming development centers. The government has established an outstanding school system to train software engineers, created tax incentives, and much more to spur development in India. If a new political party is elected with an agenda that makes it difficult to establish foreign businesses in India and utilizes local talent INFY would suffer. This has the potential to permanently alter the business. We view this political risk as remote.
    - Low Risk

Growth Opportunity

The Indian IT-BPO industry is estimated to grow from $101 billion in FY 2012 to more than $225 billion by 2020. A substantial portion of this growth will come from increased spending from INFY existing client base – meaning no additional business relationships are required to experience large gains. In addition to increased spending from existing clients INFY will benefit from the continued addition of new clients during the next 10 years.

Moat

The company's economic moat is protected by the combined effect of the following two contributing factors:

1) High Switching Costs (Industry Specific)

The high switching cost was described previously when outlining the industry conditions for IT BPO firms but will be reemphasized here. When BPO firms partner with clients the integration between the two firms is deep and switching costs are very high. Firms across the entire industry rarely lose clients due to this tight integration and have revenue retention rates in excess of 100%. These high switching costs are industry wide and not INFY specific.

2) Brand Name & Large Cap Ex (Company & Industry Specific)

When considering a large capital project it is critical to choose the right partner. Companies spend a great deal of time and energy prior to selecting a partner – and having a strong brand name in the industry is crucial during the selection process. INFY's client base consists of large enterprises with annual budgets for BPO projects ranging from 5 million to 50 million or more. Additionally, INFY has set itself apart in recent years and continues to win large contract deals from their multi-billion dollar competition. The INFY brand is exceedingly valuable when bidding for new projects.

Conclusion

INFY has achieved historical growth rates in excess of 12% for the last 5 years. The industry conditions and competitive position that lead to this success remain intact. As a whole the Indian IT-BPO industry is targeted to grow from $101 billion to more than $225 billion in the next 6 years and we believe that INFY will be able to maintain the company's current customer base and win additional clients in the ensuing years. It is our expectation that INFY will achieve annual growth in owner earnings of more than 8% for the next 10 years. This forecast is backed by the strong economic moat surrounding the business: high switching costs and a strong brand name. We paid approximately 12.5x earnings to purchase our stake in INFY and would be content selling the position in the event that the company reaches a more appropriate valuation.

Works Cited

1) *INFY Annual Report - SEC Filing 10-K.* EDGAR, 2013.
2) *Infosys IR* – Presentation March 2013.

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