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US and European Investors
following earnings for the Quarter ended 31 December 2003 (Q3-FY04)

TRANSCRIPT OF CONFERENCE CALL

9 January, 2004 - 8:30 AM US (ET)

Operator: Good morning ladies and gentlemen and welcome to the Infosys Technologies Investor Conference Call for the Third Quarter Fiscal Year 2003-2004. At this time all participants are in a listen only mode. Later we will conduct a question and answer session. Please note that this conference is being recorded. I would now like to turn the call over to Mr. P.R. Ganapathy, Investor Relations Officer. Mr. Ganapathy you may begin.

P.R. Ganapathy: Thank you very much. Good morning and hello ladies and gentlemen. Thank you for joining us to discuss the results of the quarter ended December 31st 2003, which is the third quarter of our fiscal year 2003-2004 and is also the fifth complete year in terms of quarters that we have reported since we listed on NASDAQ. I am sure you have had a chance to look at our press release and the various data sheets that we posted on our web site www.infosys.com.

I would like to take this opportunity to announce the appointment of Mr. Sandeep Shroff as General Manager, Investor Relations. Sandeep has several years of experience in the financial services industry. He was an analyst covering, among other things, our sector and some of the other offshore services players. I am sure that interacting with him you will find a rich resource with which to understand offshore IT services and Infosys. He can be reached at 510-742-2960. He will be based in the Fremont office and his e-mail ID is sandeep_shroff@infosys.com. It has been a pleasure interacting with you all over these last five years and over the next month or so I will be transitioning US IR work to Sandeep. I am sure you will find interacting with him very fulfilling.

To move on to the call today I have with me at a conference room in Bangalore, Mr. Nandan Nilekani, CEO and President of Infosys and members of his Senior Management Team. We will begin with some comments from them on the quarterly performance and their outlook and what they see from the marketplace and then we will turn it over to you all for questions. Just before I hand it over to Mr. Nilekani I have a small duty to perform in reminding you that anything that we say that refers to our outlook for the future must be read in conjunction with the risks that we face, and these risks have been detailed in our filings with the SEC. So they must be looked at in a holistic fashion. With that I will now turn over the call to Bangalore and Mr. Nandan Nilekani, President and CEO of Infosys.

Nandan Nilekani: Thank you Guns, and I would like to welcome all of you to this earnings call for the results of the quarter ended December 31st 2003. This has been a good quarter for Infosys. Our revenues for the quarter went up to $275.9 million, up 38% from the corresponding quarter last fiscal and earnings per ADS has gone up to $0.54 as opposed to $0.40 in the corresponding quarter last fiscal. This quarter we have added 30 new clients across many industries, especially telecommunication service providers and in financial services. We have also added a gross addition of 3600 employees and a net of about 3100 employees for the quarter across both Infosys and Progeon. Today the Infosys Progeon combination has over 23,000 employees.

This quarter while we have been able to meet on all the metrics of growth, earnings, A/R collection of 56 days, utilization of 82.5% etc., this has also been the quarter where we have gone through a re-organization. We have, in the US, re-organized our units into vertical IBUs along different business lines like Banking and Capital Markets, Insurance, Healthcare and Life Sciences, etc. We believe that this is the way for us to deal with our goal of going up the value chain, of meeting increasing expectations from clients, of dealing with fast changing economic conditions, and a competitive scenario where the world has accepted the global delivery model and is now looking for us to enhance it using our business knowledge and leveraging technology.

This quarter also has been significant with our first acquisition of Expert Information Systems from Australia. We are working toward a seamless integration of this. We are delighted that the CEO of Expert and now the CEO of Infosys (Australia), Gary Ebayan, is here on this call with us and will be happy to take any questions about our Australia strategy.

Our efforts also in terms of driving work offshore has worked well. Offshore utilization has gone up to 67.8% of the effort done as compared to just 63.9% for the same quarter in the previous year.

So I think this quarter has been good both in terms of us meeting and exceeding our financial performance as well as in doing a lot of strategic changes both in terms of acquisition as well as in terms of restructuring. We have laid the foundation for growth in the coming years. With this I will ask Kris, our Chief Operating Officer to go into some of the operating details, Kris.

Kris: Thanks Nandan. Geographically, Europe has increased to 20.7% of revenue from 18% of revenues. This is due to increased…over the last two quarters we have increased our marketing presence in Europe proactively and it started yielding some results. Amongst services, package implementation service again has shown improvement over the last quarter. The last quarter was 12.6% of revenues and this quarter it is 14.8% revenue. Over the last 12 months, package implementation has gone from 10% of revenue to 13.8% of revenue, actually. So clearly our objective of moving up the value chain, providing services at the upper end of this value chain is working.

In terms of the services which have been introduced over the last three or four years, this all adds up to about 30% of revenue, actually.

In terms of onsite : offshore Nandan talked about the percentage onsite coming down from 32.6% to 32.2% in terms of effort. In terms of billing rates, onsite has come down marginally by 0.6%. Blended has come down by 0.7%. But basically there is stability in prices. We are not involved in any major re-negotiations, downward revision of prices and things like that.

Our largest client constitutes 5.5% of revenues. We have two clients giving us revenue of more than $50 million over the last 12 months and 130 clients with whom we are doing business of more than $1 million. So definitely repeat business from our existing clients is a significant contributor to the growth. Repeat business is 92%. We have also added 30 new clients like Nandan mentioned.

Our attrition stands at 10% versus last quarter of 9.1%, which is a marginal increase in attrition. We have added 545 lateral employees, that is people with experience, this quarter. Again one of the largest numbers in Infosys' history. With that let me hand it over to Mohan.

Mohan Pai: Thank you, Kris. Our guidance for the fourth quarter is $290 million to $293 million and $0.55 as against $0.54 for this quarter. I want to add that the guidance for the fourth quarter does not equal any exchange variation. We had an income of $3.5 million before tax for exchange variations in the third quarter. We have not projected any exchange variations because part of the exchange variation is due to translation differences, which we will not be able to know. We have hedged our receivables to the extent of $107 million for this quarter. We also get about approximately 20% of revenues from non-US source currencies. To the extent there is a natural hedge as these currencies would move the other way.

As Kris said pricing has been stable. There has been a slight decline in onsite, which is not a cause for any great concern. Our gross profit is at 43.5% as against 43.9% the previous quarter. The decline has been because of an increase in offshore salaries basically because of variable compensation. The bonus component is higher this quarter than the previous quarter.

The SG&A expenses are at 15% as against 15.3% with Sales and Marketing being 7.5% as against 7.2%. This slight increase is due to the bonus component. G&A has come down to 7.5% from 8.1%. The decline is primarily due to declines in provisioning for overdue receivables.

Operating margin is 27.4% and other income, non-operating income is 3.4% consisting of treasury income of 2% and the balance is exchange differences. So the Rupee has been more stable in the third quarter than in the second and first quarter. We have made a provision for investment of $500,000.

Profit before taxes are about 30.6%. Taxes are 5.1%, which is approximately 13.9% on the profit before tax. Net income is at 25.6%.

Cash flows continue to be strong. Our cash balance has grown by $80 million this quarter as against the profit which has grown on a consolidated basis by $70.5 million. We have had about $50 million received on the exercise of stock options by our employees. We have spent about $18-odd million for Capex expenses this quarter. We had said earlier that we would spend $100 million to $120 million on Capex and in the nine months we have spent $48.6 and this quarter, in which you will see an acceleration of trend, we are on a consolidated basis at 23,209 employees. We are at the highest number of employees as Kris said. With this I would like to open the floor for questions, thank you.

Operator: We will now begin the question and answer session. If you have a question you need to press star one on your touch-tone phone. You will hear an acknowledgment you have been placed in queue. If your question has been answered and you wish to be removed from the queue please press the pound key. Your questions will be queued in the order that they are received. If you are using a speakerphone please pick up the handset before pressing the numbers. Once again if there are any questions please press star one on your touch tone phone. Our first question comes from Julio Quinteros from Goldman Sachs; please go ahead.

Julio Quinteros: Good afternoon gentlemen. Mohan, I have a real quick question for you. Can you just go through the contribution expectations that you have for your Australian acquisition that you just made in the fourth quarter, sir?

Mohan: This is the first quarter of the Australian operations being in our revenue base. So we have assumed a revenue of about $8 million and we assumed net income of between 8% to 10%.

Julio Quinteros: Now, on the comments that you made about the A/R provisioning; can you just walk us through that again? It sounded like you had some A/R provisioning declines associated with some overdue expenses. Is it because you collected the expenses or because you are just writing those off?

Mohan: It is just because our policy calls for provisioning in case anything goes above 180 days. In the event something goes above 180 days, there is an automatic provisioning requirement. Plus, it triggers off an event where there is a review by the CEO and the CEO's review leads to collection in the next quarter. So we have a natural hedge against any deterioration, and that has resulted in a lesser provisioning this quarter.

Julio Quinteros: I got it. Real quickly for Kris, if you can just go back through the comments you made about re-negotiations. It sounds like you do not have any major re-negotiations or you did not have any in the December quarter. Will there be any that we need to be concerned about in the next 12 months?

Mohan: I think re-negotiations this year have not been as significant as people have been thinking because at last count, we probably had 17 or 18 clients out of 357 clients and about 300 clients at the beginning of the year who came for re-negotiations. It is not as significant as people make it out to be. But there could be one or two sporadic chances of a client coming for re-negotiations and that trend is expected to continue. We were told by the head of worldwide sales that pricing continues to be stable now and he does not see the threat of any re-negotiations in the near term.

Julio Quinteros: Mohan, maybe I could just jump the gun here a little bit. As far as fiscal 2005 are you ready to give us a little bit of a preview on the outlook for 05 or maybe it is too early?

Mohan: I think it is a bit too early but I will request our CEO to make some remarks about the prospects that he sees for the future year from wherever he is today.

Julio Quinteros: That is great, thank you.

Nandan Nilekani: Thanks Mohan for giving me this opportunity to do some forecasting. I think in a broad sense the few messages that we have are (1) that the outsourcing trend continues to gain momentum in spite of the backlash and that it is becoming a mainstream point of view for many corporations across the world. We think that the US economy has grown much better in the last quarter. While we do not see IT spending itself going up too much we do believe that IT spending will get re-allocated to activities like offshore outsourcing to that extent. We think that trend is going to continue. From our side we have geared up in terms of creating the vertical units and focusing on business solutions, which we believe is the way for us to go up the value chain in the coming years. Also we are ramping up in terms of employees. As I mentioned earlier we added a gross of more than 3600 employees across Infosys and Progeon this quarter. So I think while I cannot give specific numbers I think we do believe that there is sufficient interest in outsourcing and we are gearing up both from an organizational structure point of view as well as from a capacity point of view, to deal with that.

Julio Quinteros: Nandan maybe I can follow-up real quickly then. From a different perspective about a year ago this time of the year or actually a little bit sooner than that we had heard that margins in India were going to zero. Clearly that is not the case and you guys are doing a pretty good job of holding the line on the operating margins that you have. Either you or Mohan can answer this question -- but as you look at fiscal 05 the margin projection that I think the street is kind of looking at is maybe still down. The materiality of that I guess is really sort of the open-end question as far as how much those margins come down if at all. Can you just comment directionally about margins then for fiscal 05 obviously without getting into any specifics if at all possible?

Mohan: There are three items that could impact the margins to move. The first is pricing and right now we see pricing to be stable. The second is employee compensation. The situation remains the same in as much as there is wage inflation for the project management level and at the entry level there is no significant wage inflation. The third is the Rupee : Dollar rate. We have managed to hedge the Rupee : Dollar rate in this entire year for the last 12 months by taking forward covers. The impact has not been as significant as one would think it would be. We do think that going forward there are reasonable expectations that some hedging techniques would minimize the impact if any. So the only significant feature would be any wage increase and we have a variable compensation plan, which makes it possible to ride out any significant wage increases. In case the corporation does very well we will see people getting much, much more. In case the corporation's profitability is impacted, the variable compensation would insulate the corporation to some extent. So I think we are positive about margins being stable and fluctuating in a narrow band in the future.

Julio Quinteros: Thank you very much. Congratulations on the quarter.

Operator: Our next question comes from Moshe Katri from SG Cowen, please go ahead.

Moshe Katri: Hi. I wanted to congratulate you for a very impressive quarter. I have a couple of questions here. One, what sort of wage inflation number do you think we should incorporate in our FY05 model? I know we are not talking about estimates but what is your estimate or guesstimate for wage inflation in 05 -- that is number one? Number two, the turnover rate seems to be inching again, not a huge increase. I am assuming you have some ongoing internal efforts to be able to kind of maybe just stabilize it at a certain level. Maybe you can talk about that. Then finally Europe grew I think at a very healthy 74% year over year. It seems that Europe, the whole offshore concept seems to be taking off in Europe, which has been lagging the US. Can you talk a bit about your ongoing European effort, your head count in Europe; where do you see the demand coming through and where do you see the next leg to grow in Europe, which countries?

Mohan: Well, the normal wage inflation on an overall basket basis has been 10% to 15% on salaries payable in India and about 3% to 5% on salaries payable overseas. Salaries payable overseas are typically 30% of revenues and salaries payable in India are about 12% to 13% of revenues. So if you work out that impact on that basis the impact on revenues could be between 2% to 3%, which is typically partially insulated by reduction in other costs of revenue and by a decline in G&A expenditure. So to the extent that we are able to have a blended rate higher because of going up the value chain, in terms of increased business from package implementation and other higher-value services that have greater margins this could be insulated. That is exactly what we have been doing except that last year the margins came down from 30% to 26% there is a huge pricing decline of 6% to 7% for the year plus the Rupee appreciated by 4% to 5%. So this had a significant impact the last two years and that is why margins came down. Now, as far as growth in Europe is concerned, I will request that Basab, the Head of Worldwide Sales to add a bit.

Basab: Thanks Mohan, this is Basab. In Europe, Europe is actually one of the first business units that was formed under the restructuring plan that we just concluded. So it has actually been in that structure for about a year. Some of the measures that we have taken in the market have yielded results. We have significantly increased our presence in the market in the quality and number of people in the field. That has yielded positive results for us in Europe.

Moshe Katri: Can you go into specific by countries where do you see the strongest trends in Europe today and then maybe you can go into some details in terms of your head count in Europe and maybe the number of sales people that you have on the continent as well?

Basab: I will just give you some color on the country by country growth. The UK has definitely been our strongest market in Europe. If you look at our growth this quarter over last quarter the UK was actually 26% sequentially. We are also making strides in newer markets like Switzerland. Overall there is bullishness across the continent of course in terms of our revenue. Hopefully as the economy improves next year the efforts we have made in the market on the continent in Germany, France and some of the other countries will also pay dividends.

Moshe Katri: Do you have any comments on my question regarding turnover rates?

Hema Ravichandar: The turnover rate was 10%. We had seen a slight increase from 9% to 10% since the last quarter. Primarily the reason for attrition continued to be the same; better opportunities, higher salaries and of course personal reasons.

Moshe Katri: Thanks.

Operator: Our next question comes from Adam Frisch from UBS; please go ahead.

Adam Frisch: Thank you and good afternoon. I have a couple of questions on the pricing pressure; I know you alluded to it a couple of times. But you said it was relatively stable. Onsite was a little bit down but no cause for concern. Could you just clarify how much it was down or why it is not a cause of concern. Then kind of taking it to the next level, when do you expect it to actually increase and do you expect the increase any time soon and what would make it go up?

Mohan: Onsite came down sequentially by 0.6% and offshore was stable. Offshore went up slightly but it is too insignificant a percentage. On a blended basis it was 0.7%. As far as the second part of your question, I will request Basab to answer that.

Basab: The reason why 0.6% is not significant -- one is it is quarter over quarter and also the service mix for Infosys can change quarter to quarter and the range of rates we have onsite could be different. So there is absolutely no cause for concern in the onsite rate dropping.

At the current time we think for the foreseeable future prices will be stable. At some point we will come back to you and let you know if we have the opportunity to actually take it up or we think pricing power is returning to the vendors. But at this point we cannot say that.

Adam Frisch: What kind of things would you need to see in order to increase pricing? Can you give us some benchmarks or some road posts; what would you look for?

Kris: This is Kris. Some of the things we can probably look out for is inflation going up, wages going up in the market, client budgets increasing, supply and demand situations and things like that. So these are some of the external parameters we would also look for. At that point we may feel more comfortable going back to the clients for higher pricing.

Adam Frisch: If I could just switch to the US operations for a second can you talk about your US operations here; how many people you have, where they are basically disbursed and what they are doing and what you expect that head count to be 12 months from now?

Mohan: We have about 4800-odd people who are outside of India at this point in time of whom 3900 could be in the US. But you must remember that these are people who go there. A large number of people go there for a short term and come back. They are not permanent residents there. The permanent residents in the US would be anything between 400 to 600 people. Our model is predicated upon people going short-term to the US for specifications, coming back here and doing their work here. So we will always be having this kind of movement to and fro. But the significant thing is we have been driving more work offshore. So to that extent our offshore effort is at 32.2% as against 35.6% the same quarter last year. I am sorry; that is the onsite effort. We managed to drive more work offshore and this is helping us in terms of being more competitive because it results in better value for the client. In terms of better percentage margins though we will not be on a per-capita basis.

Adam Frisch: What is the head count that you predict for 12 months from now in the US, the permanent head count of 400 to 600 people. What would that be in a year?

Mohan: We do not think the permanent head count will increase in any significant manner because that is not the model that we operate. We have a bench onsite. For 4800 people we could have an unbilled bench of something like 100 to 110 people. We do not think that un-billed people increase in any significant manner.

Adam Frisch: My last question here is can you also take about any M&A plans that you have where you think you need to beef up your current operation?

Mohan: Yes we do have M&A plans all the time. We have a team that works full time on scanning the landscape to see what is a good company to invest in. It takes some time. We need to have a candidate that meets with whatever cultural compatibility issues that we have. Culture also means that they must be able to have good growth rates, good margins, a very clean balance sheet, good management; it is a long list.

Adam Frisch: Have you been focusing your efforts on geography or skill sets at this point?

Mohan: I think we focus both in Asia-Pacific, Europe and in America. We have seen like our CEO said about 130 companies in the last three or four years. We came close to some acquisitions in two or three cases. But we finally made it in Australia. We fell in love at first sight, down under because of the thunder down there and it worked out. Basically it was a perfect match because it is a great company, well run, well managed, very good margins and very good growth.

Adam Frisch: Thank you very much. I appreciate you answering my questions.

Operator: Our next question comes from Mayank Tandon from Janney Montgomery Scott; please go ahead.

Mayank Tandon: Good afternoon. I had a couple of questions on your move up the value chain. Could you talk specifically about the nature of the contracts out there these days in terms of are you having to compete against Accenture and IBM on just general contracts that have an offshore component or are these exclusively offshore-centric deals?

Basab: This is Basab. I think we end up competing against them on select deals of both kinds. Both outsourcing deals where the company has made up its mind that they want to do this offshore. Also system integration deals where the company perhaps does not care as much where the work gets done but is definitely interested in getting a quality product on time at a decent price.

Mayank Tandon: Actually the nature of my question has more to do with what are the kinds of deals out there? Are the clients separating deals between onsite and offshore or are they looking for just the best solution and then bringing in different vendors to bid on these contracts not really caring how the project is executed?

Nandan: I think currently in the customer mind there is a very high awareness of the global delivery model and the price : performance benefits of being able to leverage offshore. So in fact in almost every situation the customer is designing needs from the assumption that a part of it, an essential part of it will be delivered offshore. In a sense therefore, offshore is becoming “sine qua non” -- sort of a prerequisite for most deals and is very inherent. Having decided that offshore is part of it typically the companies choose to call some offshore pure plays like Infosys and others and of course call a couple of the bigger incumbents. So that is typically the mix that we see when there is an outsourcing strategy being played out.

Mayank Tandon: This will also be on some of the maintenance-type contracts or does that tend to be more of the domain of just the pure play offshore names?

Nandan: This could be for maintenance. This could be for enterprise deployment or SAP, Oracle. This could be for application development. This could be for infrastructure. I think the important thing is that this is now applying across the board across services and every major situation the customer is asking for offshore. In fact there is one situation where a very large automotive company is bidding for its benefits to be outsourced, like 401K plan and they are insisting that they also be supplied offshore. So I think we are seeing the offshore sort of permeating into the supply chain of every company.

Mayank Tandon: So competitively how has the landscape changed? Are Accenture and IBM more competitive today on the offshore front or would you say the environment is very similar to say two or three quarters ago?

Nandan: Well, the incumbents are very reluctant offshorers because the offshore model is fundamentally disruptive to them. Usually they are going into offshore because the customers are leading them by the nose to do that. What is happening is that while they are offering offshore it generates a lot of inherent conflicts of interest internally between the local operations and the offshore operations. We believe it leads to a lot of disruption. So I think in a sense the rules of the game have changed; offshore is a way of life. And for companies like Infosys whose organic model is offshore are fundamentally better place than those whose model is onsite-centric. Now they are being forced by the marketplace to change the way they do things.

Mayank Tandon: I have a very general question again in terms of moving up the value chain. What are some of the challenges you as a company face when you take on some of these higher-end systems integration engagements? Is it more the execution of the onsite-offshore model driving resources offshore or are there other management challenges that you face in some of these larger and more sophisticated contracts?

Nandan: I think at the end of the day moving up the value chain is nothing but delivering service to the customer and the customer perceives that these services deserve paying a better price. That is really what value chain is all about. It is all about getting better prices. We think that there are a number of ways to get those better prices. What we are trying to do is, along with our organizational restructuring, we are bringing a lot more focus on the solutions approach, where our business units are encouraged to go the market with specific solutions that are perceived by the customer to be of higher value. We are focusing on working in alliances. We have stepped up our alliance activity. We have an alliance team working with majors like Microsoft, SAP, Informatica and many others. We are of course looking at potential acquisitions. So I think we have a very strong stockpile of technological R&D from our R&D labs called SETLabs. Now we are looking at leveraging that intellectual property to make our customer's businesses more efficient and more effective. So I think essentially for us going up the value chain is differentiating through solutions, through intellectual property, through alliances, through acquisitions and essentially creating much better solutions for the customer so that they willing to pay more money.

Mayank Tandon: The amount of effort onsite : offshore does that tend to be pretty similar to your other type of work or is that more heavily weighted to onsite at this point but will move offshore over time as you develop your delivery?

Nandan: Different services do tend to have a different ratio of onsite and offshore. For example in our enterprise systems it tends to be almost close to 50/50. But I think one of the things that we are doing is that we are looking at each service value chain and disaggregating its components and trying to understand which of them are best done locally and which of them are best done offshore. So as we go up the experience curve in each service we will expect the offshore content to go up. In any case since this is a gradual shift in the mix it does not change that much the overall onsite-offshore mix and therefore does not materially impact the cost structures.

Mayank Tandon: Just one final question on wages; when did the wage hikes go into effect in this fiscal year and also any impact from the poaching or the perceived poaching by some of the larger integrators in India causing the turnover rate to go up a little bit?

Nandan: Typically our salary increases happen in the month of April for the new financial year. But as you will notice our compensation pattern in the last couple of years it has increasingly gone to a variable compensation linked to individual, business units and corporate performance. Therefore if the company does better then employees also get paid more and that is the alignment of interest. That is as far as the compensation goes. To the other question, yes our attrition has gone up compared to last year. We are losing some people but we are taking every effort, both in terms of addressing employees' needs as well as aspirations to make sure that we retain the best and the brightest.

Mayank Tandon: Thank you.

Operator: Our next question comes from Mitali Ghosh from Merrill Lynch; please go ahead.

Mitali Ghosh: Just focusing a bit more on the moving up the value chain. You did mention, Nandan, that essentially it means getting higher prices for the work that is done, probably providing more solutions. So is it fair to assume that while moving up the value chain would assume higher prices, it is not necessarily going to result in higher percentage margins. To that extent Infosys is really focusing more on absolute profit growth than percentage margins.

Nandan: Well, obviously if you deliver higher prices with a lot of onsite resources and the costs are also high then the margins will be lower. So when we look at this value chain we are looking at both improvement of the prices as well as improvement of the contribution from each effort man-month.

Mitali Ghosh: I guess what I am driving at is the fact that for example consulting; while it is likely to get much higher prices typically one finds the margin percentages of all the leading global consultants being much lower. So the newer services, which I like to consider higher up the value chain like IT outsourcing, systems integration, consulting etc. Are they not all typically a lower margin percentage in nature?

Nandan: Which one?

Mitali Ghosh: Systems integration and consulting.

Nandan: I think we have to look at this with a fresh mindset. What we are saying is that essentially the whole business of fulfilling customers through IT services is going through a paradigm shift. Essentially every service that you can deliver to the customer in the old fashioned way can now be reconfigured for delivery using the global delivery. That is really what we are doing. We believe therefore that the historic margins may or may not be applicable as we reconfigure these services. Even in consulting, while I agree with you that consulting onsite will not have the same margins though they will have higher price points. The whole idea is that consulting is to generate downstream business and because it is driven from a consulting assignment rather than a pure outsourcing relationship. The idea is that not only do we get higher prices on the consulting but we get higher prices on the downstream work, which we would be done offshore, which will have good margins. So I think that is really the strategy.

Mitali Gosh: The second question is really on your guidance for next quarter, which if we exclude the revenues from the acquisition that you have made then we are really looking at a fairly muted 3% kind of quarter on quarter growth. So I just wanted to understand what are the uncertainties that you are really building into this guidance and if you could take us through some of the bottlenecks that you think might happen?

Mohan: We think that business is basically about managing constraints. One of the constraints that we had in the first two quarters was lack of adequate people to meet the aspiration of clients. So we have added on a lot more people. We want to grow a bench to meet any sudden requirements of clients. To that extent that constraint is slightly reduced. The second constraint could be our ability to increase our sales and our selling force. Our guidance is based upon what we see as on date. But you must remember that we are at the beginning of the quarter. As the quarter progresses the revenues become that much more clear. At the beginning of the quarter we typically have about 85% or 90% clarity on the revenues in terms of income which is there and which can be felt. As the quarter goes on it increases in most cases. So you must see our guidance in this context.

Mitali Ghosh: So Mohan if you have 85% to 90% clarity then to that extent is that not a fairly high visibility that one has?

Mohan: Mitali let me explain this. We are system based. We have got a system on which all project managers put in their expectations of revenue. Whatever the systems says, we stand up and talk. We tell our sales force to go all out and sell and they try their best to increase the revenue and we work like that. But our guidance is based upon what is there on the system and typically this is the ratio that we have seen.

Mitali Ghosh: I guess one question for Basab. What is it that is really driving the demand that you are seeing at this point in time and how sustainable do you feel this really is? Is that people are really doing a lot of development work or are they still focusing on outsourcing some of the maintenance? Another concern I have is in package implementation, which tends to be a bit volatile. I was wondering whether because package has gone up this quarter, is it one of the reasons why next quarter could be a bit muted?

Basab: The prime driver of demand growth is that offshore is now mainstream in this industry. There is almost no CIO today who is either not doing offshore outsourcing in his job or is not being questioned by his CEO on when he is going to start. So it is so mainstream that is cuts across industries, it cuts across all kinds of service offerings within package implementation, development, maintenance and what have you. So I would say this is a secular increase in demand for offshore outsourcing that will…during the last two years in a fairly depressed IT spending environment you have seen how we have grown and how the whole offshore outsourcing part of the industry has grown. In the coming years if the economy improves and IT spend improves we think good days will continue.

Mitali Ghosh: So you have seen not so much of new development work.

P R Ganapathy: Mitali could we hold your questions. We will come back to them after we go through the other questioners that are waiting.

Mitali Ghosh: Sure.

P R Ganapathy: Thanks a lot. We will go to the next caller.

42:27

Operator: Our next question comes from David Grossman from Thomas Weisel Partners; please go ahead.

David Grossman: Thank you. If I could just ask a couple of questions about the expenses; I think Mohan you talked about the sequential gross margin compression being partially a result of bonuses and variable compensation. Can you help us understand how the variable compensation flows through the P&L and is there some seasonality to it and what impact it may have on margins going forward?

Mohan: David, we have configured our compensation plan in such a manner that above a certain base level of revenue the inflow of compensation to employees is higher than the growth rate of revenue from that point. This is to make sure that we are insulated on the way down and at the same time on the way up the credit to them is much higher than the growth rate of revenue. So we think that if we grow revenues faster than the way we have budgeted, it means that our expense level in other areas would be less. To that extent we can afford to pay more to our employees and by this we align our employees' interest almost perfectly with us. For example, in this quarter the total employee cost as a part of our cost of revenues was at 45.4% as against the last quarter, which was 43.6%. So there has been an increase. There has been an increase of something like 1.8% and it has come entirely because of the bonus factor, which kicked in. The bonus is on three grounds. The first is that we have a bonus for the growth of revenues at the corporate level. Second, the bonus is paid on the unit performance along with the margin level and the third is based upon individual performances. So we have detailed set of metrics that kicks in and the model works quite well to align interest. We have countered the increase in employee cost because of the variable costs by making sure that other costs have come down. You notice that other costs of revenue have…gross margin has declined by 0.4% whereas the employee cost has gone up by 1.8%. So 1.4% has been the decline in other costs of revenue. By this I think we have a good model going forward.

David Grossman: Maybe just going over another line item looking at the amortization expense just to digress for a minute; that seems to have kind of bounced around. Is there some variability in that number as well?

Mohan: No. The amortization was very specific to an event that happened this quarter. We had a review of our banking group and we felt that the treasury product did not have the carrying cost it had on the balance sheet. So we accelerated the amortization in this quarter, so now we do not have any intangible assets to amortize.

David Grossman: Going forward what would we expect on a quarterly basis from amortization?

Mohan: Well, I think for amortization we do not have any tangible assets amortized so there is nothing to amortize. In terms of deferred stock compensation we had a small amount and even that is gone so both the balances become zero.

David Grossman: How much was the incremental piece that you took of the assets that you amortized during the quarter that you just mentioned?

Mohan: This quarter we had amortization of $2.6 million as against $3.3 million and the extra amount that we took was something like about $1.2 million this quarter compared to what would have happened in case we didn't have this acceleration.

David Grossman: Then just on the tax rate, can you give us a sense of how that may trend next year? I guess you did 16.5% and it has been bouncing around again this year. Can you give us a sense of what it may look like next year?

Mohan: Yes. We have two streams of revenue on which we pay tax. One is the offshore revenue and a very significant part of the offshore revenue is exempt from tax until 2009, with declining percentages from 2007 onward. Next year, that is fiscal year 2005 a part of our facilities will come into the tax net. But that will be only be to the extent of 6%-7% of our revenues; which will not be significant. Our offshore tax is basically based upon the other income that we have, the non-operating income that we have. The non-operating income will be taxed at 35%. On the onsite basis our tax rate to revenues has been something like 3.7%. So this year I think we will have something like 14%-14.25% and going forward that percentage should not shift significantly.

David Grossman: I am sorry. I guess I did not follow all those numbers. So going forward I think you just reported at least on the US GAAP that you have a tax rate of about 16.5%. Is that a good number for 05 or do you think based on some of the parameters you just outlined that goes up?

Mohan: I think going forward barring any increase in non-operating income, which we cannot predict now because of exchange variation because that would trigger tax charge on that. We should expect something like maybe 14-14.25% on the pre-tax income.

David Grossman: In terms of the head count you had pretty robust net adds obviously during the quarter. Can you give us a sense of kind of what you would expect to add in the fourth quarter in terms of head count?

Hema Ravichandar: Hi, this is Hema here. We expect to add another 1500 employees in the fourth quarter.

David Grossman: Is that net or gross?

Hema Ravichandar: Gross excluding of course Progeon and Infosys Australia.

David Grossman: I am sorry; including or excluding?

Hema: Excluding Progeon and Infosys Australia.

David Grossman: Maybe one question for Nandan; I know there have been several questions on the general pricing environment. Looking at your unit volume growth, which has been extremely high over the last several quarters and I think others in the industry have been experiencing similar volume growth. I think we can arguably say that demand trends are extremely strong right now. Looking at some of the wage numbers it would seem to appear that there are some constraints on supply as well. So since we have a pretty favorable environment right now and I know you talked about pricing stability but have been somewhat reluctant to talk about the ability to raise prices. What is the governor right now on pricing going up given what appears to be a very favorable environment right now, both from a supply and a demand perspective?

Nandan Nilekani: I think there are really two or three factors for pricing going up. One is obviously if the demand / supply becomes short in the sense that there is a shortage of skilled people and that drives price up. Frankly I do not see why that should happen in a hurry because to go back to the 90s I think when this offshore model was not fully recognized I can understand that pricing could have gone up because of shortages. But in today's model with global delivery being accepted as the global approach for outsourcing and supply being quite high it is not clear to me why pricing should go up from a demand supply perspective. The second thing is that pricing can go up if our customers start loosening their purse strings. Our customers themselves continue to face immense pressure in terms of raising their prices and raising their growth. So they obviously would like to keep a tight lid on what to buy from their vendors. So I think really the best way for us to do something about pricing is really to change the value perception of what they buy from us, which is why our whole effort internally to focus on business solutions, to focus on alliances, to focus on leveraging IP is that if we can really sort of unlock the intellectual capital of what we have and come up with better solutions and convince a customer that these better solutions merit a better price. That is the best way that we think we can get pricing power and not really based on macro issues.

David Grossman: It sounds like from your comments earlier in the call that you think that you can continue to do that without having to change the mix of effort onsite versus offshore. Is that a fair assumption?

Nandan Nilekani: I think a lot of that really has to do with the scale of operations. The fact is that we have maybe 5000 of our people onsite and another 15,000 or 17,000 people offshore. Even if you wanted to embed a lot of solution activity inside that and that requires onsite to go up by a few hundred people it won't really make a difference on the macro balance sheet.

David Grossman: I see; thank you very much.

Operator: Our next question comes from Mahesh [Inaudible] from SSKI, please go ahead.

Mahesh: I have a couple of questions. Firstly, your product revenues have come down from the Rs. 290 million in the fourth quarter last fiscal to about Rs. 180 million this quarter. What exactly is happening in that business? Secondly, I wanted to understand what is the strength of the consulting business in terms of number of people currently and where are they located?

Mohan: You said that product revenue has come down this quarter compared to the previous quarter. Is that what you are saying?

Mahesh: It has been coming down for some time. In the fourth quarter it was almost Rs. 290 million, which has come down to Rs. 180 million.

Mohan: Yes. It has come down from $8.67 million to $7.25 million this quarter. That is because the banking business, the enterprise banking business has been flat for some time. The revenue recognition is choppy because even though you may bill and get revenue, recognition is spread over the implementation phase. So there has been some choppiness but the business has not been growing. What was the second question?

Mahesh: The second question is regarding the consulting business strength; what is the current strength in terms of number of consultants?

Kris: We have about…from a pure business consulting perspective…we have 120 people.

Mahesh: Where would they be based out of?

Kris: They are based all over the world actually. In all geographies they are present. In the new structure they are present in the different business units also.

Mahesh: Just like your offshore business does the consulting bench also lie in Bangalore?

Kris: Yes. We are doing some of the back office research with a small group in Bangalore.

Operator: Our next question comes from Michael [inaudible] from Murray Research; please go ahead.

Michael: Hi. I just wanted to ask a couple of short number questions. What percentage of your European business is based in the UK?

Mohan: All this data is on a fact sheet that we have on the web. Our UK business is 8.4% of revenues.

Michael: Thank you. There is another piece of information, which is also missing from the fact sheet, which is the annualized offsite and onsite per capita rates. Given the last quarter on the call as being 131 and 54K annualized so I was just wondering what they were for the quarter please.

Mohan: I will just give you the number; just hang on a minute.

Michael: Just finally I know you had like an enormous amount of questions on pricing but just to sort of ask one final one. In the fourth quarter in fiscal 02 you had a pricing drop of 4.8% overall and then last year you had a 5.1% in the first calendar quarter. What you are saying is that you are expecting a drop of 0% basically in the first quarter this year despite 5% drops the last two years in a row.

Mohan: This quarter we are at $130,269 as against $131,110 on an annualized basis for 0.6% drop. Yes, the fourth quarter of last year we had a drop in per capita for both onsite and offshore. There were many reasons for that. One reason was that some clients came back and re-negotiated asking us to take incremental business because their year runs from January to December whereas our year runs from April to March. That is one. The second is there were some pricing declines because of some shift in businesses. Some of the per capita, higher per capita revenue business had come down during that period. It does not mean that there is a trend that every fourth quarter there would be a decline. Nor a trend that every first quarter of the subsequent year there would be an increase. We do think that at this point in time the prices are stable but on a quarter on quarter basis there is a possibility for variation because of the fact that there is a different per capita rates for different revenues. Depending upon which part of the revenue would grow we would see some slight change.

Michael: The offsite number was not given.

Mohan: The offsite number for the second quarter was 53,980 and the third quarter 54,007.

Michael: Excellent; thank you very much for that.

Operator: Our next question comes from Ashish Thadani from Brean Murray; please go ahead.

Ashish Thadani: Good evening; nice quarter. My question has to do with operating margin. To the company's credit operating margin is above that of industry peers. In your view would it be a reasonable expectation that the current range should narrow over time? Secondly does Infosys believe that its investment strategy is broadly comparable with the same set of peers, more aggressive or less?

Mohan: We would think that in any industry the operating margin would be in a range with very high quality companies being at the top of the range. Going forward that will be the story. It is our intention to make sure that operating margins are at a good level. As far as investment goes yes, we do have this statement from some competition that they are making some significant investment in sales and marketing. We have 264 people outside India selling all the time; very high quality people. We make significant investments in them. For example, our sales and marketing is at 7.5% and that is $75 million on a billion dollars of revenue, which is significant for a company of our size. So we intend to invest in sales and marketing on an ongoing basis. We shall do what is an adequate investment to make sure that the model is robust and strong.

Kris: We have time for one last question.

Operator: We have George Price from Legg Mason online.

George Price: Actually at this point all of my questions have been answered.

P R Ganapathy: Thank you George, and thank you ladies and gentlemen for participating in this call. We look forward to speaking with you in the course of this quarter and then after that of course when we announce results for year and quarter ended March 31, which will be in early April. Thanks and have a great day.

Operator: Thank you. Ladies and gentlemen this does conclude today's teleconference. Thank you for participating; you may now disconnect.