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United States of America

Services

Business Process Services

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## Amdocs Ltd. (DOX - US\$ 34.44) 1-Overweight

Earnings Review/Sales Analysis

Despite Hiccup, LT Fundamentals Intact

### Investment Conclusion

- Consistent with preannouncement, 1Q07 results were inline with Street expectations. FY07 EPS was reduced to \$2.02-2.12 from prior range of \$2.08-2.16, but slightly better than our latest projection.

### Summary

- So what to make of the guidance cut? We think there are two factors. 1) Despite DOX's steady performance in recent quarters, the inherent lumpiness in DOX's model (a focus on the largest projects at the biggest carriers) may not always be easy to smooth out. Here, decision delays at AT&T, Vodafone and DT appear to be causing the slower demand. 2) DOX may have been a bit too optimistic two quarters ago when setting very high FY07 guidance.
- While annoying, lumpiness should be less of an issue for true long-term investors. We have confidence that significant pent-up demand remains at the telco back-office, and DOX is able to address those needs better.
- Is the new guidance conservative enough? It seems quite possible given the healthy backlog growth, strong existing business, and potential flexibility DOX may have in margins.

### Stock Rating

New: 1-Overweight  
Old: 1-Overweight

### Target Price

New: US\$ 44.00  
Old: US\$ 44.00

Sector View: 2-Neutral

### EPS (US\$) (FY Sep)

	2006		2007		2008		% Change	
	Actual	Old	New	St. Est.	Old	New	2007	2008
1Q	0.42A	0.50E	0.53A	0.50E	N/A	N/A	26%	N/A
2Q	0.44A	0.49E	0.49E	0.51E	N/A	N/A	11%	N/A
3Q	0.49A	0.51E	0.50E	0.53E	N/A	N/A	2%	N/A
4Q	0.50A	0.53E	0.53E	0.55E	N/A	N/A	6%	N/A
Year	1.85A	2.02E	2.05E	2.09E	2.30E	2.30E	11%	12%
P/E			16.8			15.0		

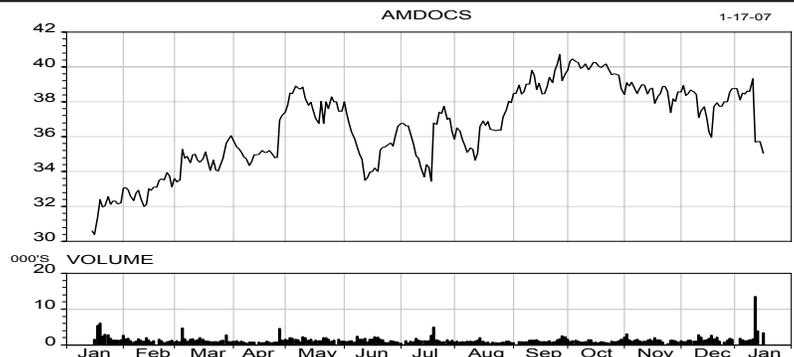
### Market Data

Market Cap (Mil.)	7618
Shares Outstanding (Mil.)	221.20
Float (%)	162
Dividend Yield	0.00
52 Week Range	41.01 - 29.89

### Financial Summary

Revenue FY07 (Mil.)	2861.0
Five-Year EPS CAGR	15.0
Return on Equity	19.90
Current BVPS	7.28
Debt To Capital (%)	22.20

### Stock Overview



### Inline quarter, FY07 EPS cut slightly less than feared

Consistent with last week's preannouncement, DOX reported an inline 1Q07. Revenue of \$691M was up 18% y/y (roughly 10% organically), inline with Street. EPS was \$0.53, including a one-time tax benefit of \$0.03; excluding that, EPS matched Street consensus of \$0.50.

In terms of guidance, DOX is guiding for 2Q07 revenue of \$705M and EPS of \$0.49-0.51. FY07 revenue is to be \$2.83-2.91B, 2% lower than the prior guidance (as pre-announced). FY07 EPS is to be \$2.02-2.12, with the midpoint being \$2.07, which is \$0.05 below the prior midpoint of \$2.12 (the guidance range was \$2.08-2.16). If we exclude the 3-cent tax benefit in this quarter, midpoint guidance becomes \$2.04, \$0.08 below last guidance. Last week, we conservatively cut our FY07 EPS to \$2.02. So the new guidance is in fact slightly better than what we anticipated.

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We modestly tweak our estimates. Our FY07 EPS goes slightly up to \$2.05 from \$2.02, and our FY08 EPS is unchanged at \$2.30. Our 12-month price target remains \$44, based on 19x our FY08 EPS estimate of \$2.30.

#### **Slower demand in transformation projects, what to make of it?**

DOX indicated that the reason for the guidance cut (by 2% in revenue and 4% in EPS) is because mgmt is seeing the demand for large transformational projects taking longer to materialize, but the existing business remains strong. Previously one investor fear was that carriers may be cutting spending of ongoing projects, which now doesn't appear to be the case.

In addition, the slower decision-making to undertake large projects doesn't seem to be motivated by either a fundamental rethinking on the part of carriers on billing consolidations, or concerns about a slowing economy. DOX cited the delay of the AT&T/BellSouth merger, the restructuring at Vodafone, and mgmt change at Deutsche Telekom, as all having contributed to the slower-than-expected demand for new projects in FY07.

In our view, nothing has changed fundamentally in terms of carriers' pent-up needs to improve or replace their vast array of legacy systems, in order to introduce new services, cut operating expenses, and become more competitive. So what to make of the guidance cut? We think there are likely two factors.

First, given that DOX is heavily concentrated in a handful of top-tier global carriers and given its model to focus on the largest, most complex BSS projects, lumpiness should be a fact of life. While DOX tends to have considerable visibility in the ongoing outsourcing or maintenance revenue streams, predicting large brand new wins (versus the scope increase of current projects) in the coming six to 12 months seems much tougher, given that there are likely not too many decisions to be made during a period of time and each decision could hinge on the unique circumstance of individual telcos.

Second, besides this lumpiness, in our view, DOX has also made some error in forecasting near-term demand and guiding the Street. Recall just two quarters ago, DOX voluntarily gave FY07 guidance which was considerably above Street. In hindsight, DOX may be a bit too optimistic.

With DOX's track record now dented and shares off 12% since the preannouncement (versus a flat S&P), the key question is – is the new guidance sufficiently conservative? It seems quite possible, given that except mgmt's caution about new projects, most other indicators still look quite positive – 1Q07 was in line, backlog was up a healthy 2% q/q, the 13 wins, ongoing projects remain strong, and the flexibility that DOX may have in margins, which we discuss below.

#### **Services gross margin remains quite strong, could R&D come down?**

Services gross margin came in at 37.8%, up 100 bps y/y, but down 60 bps q/q due largely to the full-quarter impact of Cramer. Operating margin was 17.4%, up 10 bps y/y but down 90 bps q/q. R&D was noticeably high at 8.5%. In fact, it was at the highest level in three years, and 120 bps above the 7.3% in FY06, despite mgmt's prior intention to lower it and derive operating leverage. We are modelling the R&D percentage to be 8.1% for FY07. If R&D could come down to 7.3% (flat y/y), the additional improvement of 80 bps would add \$0.09 to EPS, according to our estimates.

**Figure 1: DOX Income Statement**

	F2005A	F1Q06A	F2Q06A	F3Q06A	F4Q06A	F2006A	F1Q07A	F2Q07E	F3Q07E	F4Q07E	F2007E	F2008E
Revenue	2,038.6	587.0	601.1	626.4	665.4	2,480.1	691.0	699.7	720.4	748.5	2,859.7	3,088.4
Cost of Services	<u>1,295.7</u>	<u>370.8</u>	<u>385.5</u>	<u>399.5</u>	<u>410.0</u>	<u>1,565.8</u>	<u>429.9</u>	<u>439.1</u>	<u>455.7</u>	<u>471.1</u>	<u>1,795.7</u>	<u>1,938.6</u>
Gross Profit	743.0	216.3	215.6	227.0	255.4	914.3	261.2	260.6	264.7	277.4	1,063.9	1,149.8
<b>Excluding Intangible Amortization</b>												
R&D	144.5	42.0	41.1	45.2	53.7	182.0	58.7	57.4	57.6	58.4	232.1	225.5
SG&A	<u>232.1</u>	<u>72.9</u>	<u>68.3</u>	<u>69.4</u>	<u>80.0</u>	<u>290.6</u>	<u>81.9</u>	<u>82.6</u>	<u>83.6</u>	<u>86.1</u>	<u>334.2</u>	<u>339.7</u>
Operating Income	<b>366.4</b>	<b>101.3</b>	<b>106.2</b>	<b>112.4</b>	<b>121.8</b>	<b>441.6</b>	<b>120.5</b>	<b>120.7</b>	<b>123.5</b>	<b>133.0</b>	<b>497.7</b>	<b>584.6</b>
Interest Income and Other, net	22.3	8.4	10.3	14.9	8.1	41.7	11.7	10.0	10.0	10.0	41.7	44.0
Pretax Income	388.7	109.7	116.5	127.3	129.8	483.4	132.3	130.7	133.5	143.0	539.4	628.6
Income Taxes	77.7	19.8	21.0	21.1	20.3	82.2	14.2	22.2	22.7	24.3	83.4	106.9
Tax Rate	20.0%	18.0%	18.0%	16.6%	15.6%	17.0%	10.7%	17.0%	17.0%	17.0%	15.5%	17.0%
Net Income, pro forma	311.0	90.0	95.5	106.2	109.5	401.2	118.116	108.5	110.8	118.7	456.1	521.7
EPS, pro forma	<b>\$1.45</b>	<b>\$0.42</b>	<b>\$0.44</b>	<b>\$0.49</b>	<b>\$0.50</b>	<b>\$1.85</b>	<b>\$0.53</b>	<b>\$0.49</b>	<b>\$0.50</b>	<b>\$0.53</b>	<b>\$2.05</b>	<b>\$2.30</b>
Diluted Shares	217.2	214.9	217.9	220.1	221.2	218.5	222.7	223.4	224.1	225.4	223.9	228.2
Effect of Assumed Conversion	3.9	1.0	1.0	1.0	1.0	4.0	1.0	1.0	1.0	1.0	4.0	4.0
<b>Including Intangible Amortization</b>												
Amortization of Purchased Intangibles	15.4	7.6	7.5	8.5	14.0	37.6	17.7	17.7	15.0	15.0	65.4	40.0
Options Expense		11.1	9.9	10.9	14.2	46.2	15.3	15.3	15.0	15.0	60.7	60.0
Charges and In-process R&D	<u>12.6</u>	<u>0.0</u>	<u>0.0</u>	<u>8.4</u>	<u>17.3</u>	<u>25.7</u>	<u>0.0</u>	<u>7.5</u>	<u>0.0</u>	<u>0.0</u>	<u>7.5</u>	<u>0.0</u>
Operating Income	338.5	82.7	88.8	84.5	76.2	332.1	87.5	80.2	93.5	103.0	364.2	484.6
Pretax Income	360.8	91.1	99.1	99.4	84.3	373.9	99.2	90.2	103.5	113.0	405.9	528.6
Income Taxes	72.2	15.8	17.3	13.8	8.3	55.2	5.9	15.3	17.6	19.2	58.0	89.9
Tax Rate	20.0%	17.3%	17.5%	13.9%	9.9%	14.8%	5.9%	17.0%	17.0%	17.0%	14.3%	17.0%
Net Income	288.6	75.3	81.8	85.6	75.955	318.6	93.342	74.8	85.9	93.8	347.9	438.7
EPS	\$1.34	\$0.36	\$0.38	\$0.39	\$0.35	\$1.47	\$0.42	\$0.34	\$0.38	\$0.42	\$1.55	\$1.92
<b>% of Revenues</b>												
Cost of Services	63.6%	63.2%	64.1%	63.8%	61.6%	63.1%	62.2%	62.7%	63.3%	62.9%	62.8%	62.8%
Gross Profit	36.4%	36.8%	35.9%	36.2%	38.4%	36.9%	37.8%	37.3%	36.7%	37.1%	37.2%	37.2%
<b>Excluding Intangible Amortization</b>												
R&D	7.1%	7.2%	6.8%	7.2%	8.1%	7.3%	8.5%	8.2%	8.0%	7.8%	8.1%	7.3%
SG&A	<u>11.4%</u>	<u>12.4%</u>	<u>11.4%</u>	<u>11.1%</u>	<u>12.0%</u>	<u>11.7%</u>	<u>11.9%</u>	<u>11.8%</u>	<u>11.6%</u>	<u>11.5%</u>	<u>11.7%</u>	<u>11.0%</u>
Operating Income	<b>18.0%</b>	<b>17.3%</b>	<b>17.7%</b>	<b>17.9%</b>	<b>18.3%</b>	<b>17.8%</b>	<b>17.4%</b>	<b>17.3%</b>	<b>17.1%</b>	<b>17.8%</b>	<b>17.4%</b>	<b>18.9%</b>
Pretax Income	19.1%	18.7%	19.4%	20.3%	19.5%	19.5%	19.1%	18.7%	18.5%	19.1%	18.9%	20.4%
Net Income, pro forma	15.3%	15.3%	15.9%	16.9%	16.5%	16.2%	17.1%	15.5%	15.4%	15.9%	15.9%	16.9%
<b>% Growth y/y</b>												
Revenue	14.9%	25.0%	23.1%	23.5%	16.1%	21.7%	17.7%	16.4%	15.0%	12.5%	15.3%	8.0%
Cost of Services	15.4%	25.2%	23.9%	22.8%	13.0%	20.8%	15.9%	13.9%	14.1%	14.9%	14.7%	8.0%
Gross Profit	14.1%	24.7%	21.7%	24.7%	21.4%	23.1%	20.8%	20.9%	16.6%	8.6%	16.4%	8.1%
<b>Excluding Intangible Amortization</b>												
R&D	14.3%	27.7%	23.6%	44.1%	14.5%	26.0%	39.7%	39.6%	27.4%	8.7%	27.5%	-2.9%
SG&A	<u>10.3%</u>	<u>32.7%</u>	<u>25.1%</u>	<u>22.9%</u>	<u>21.0%</u>	<u>25.2%</u>	<u>12.4%</u>	<u>20.9%</u>	<u>20.4%</u>	<u>7.7%</u>	<u>15.0%</u>	<u>1.7%</u>
Operating Income	16.7%	18.4%	19.0%	19.4%	24.9%	20.5%	19.0%	13.7%	9.9%	9.2%	12.7%	17.5%
Pretax Income	21.9%	21.2%	22.7%	29.3%	23.9%	24.3%	20.5%	12.2%	4.9%	10.1%	11.6%	16.5%
Net Income, pro forma	25.0%	24.3%	25.8%	34.8%	30.6%	29.0%	31.3%	13.5%	4.4%	8.3%	13.7%	14.4%
EPS, pro forma	<b>23.6%</b>	<b>25.5%</b>	<b>26.0%</b>	<b>32.4%</b>	<b>27.2%</b>	<b>28.0%</b>	<b>26.5%</b>	<b>10.7%</b>	<b>2.5%</b>	<b>6.3%</b>	<b>10.9%</b>	<b>12.1%</b>

Source: Company information, Lehman estimates

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**Company Description:**

Amdocs is a leading provider of mission-critical customer care & billing and systems integration services (96% of FY04 revenue) and software (4% of FY04 revenue) primarily for the telecom industry.

Important Disclosures:

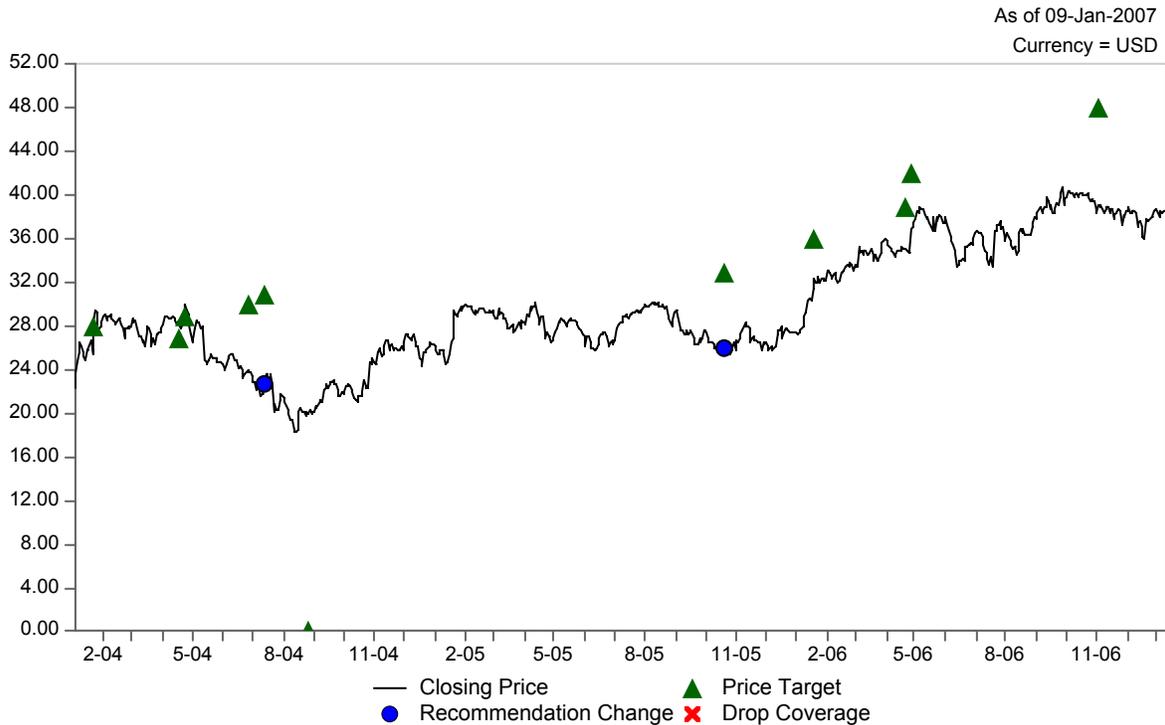
**Amdocs Ltd. (DOX)**

**US\$ 34.44 (17-Jan-2007)**

**1-Overweight / 2-Neutral**

Rating and Price Target Chart:

### AMDOCS LTD.



Source: FactSet

Currency=US\$

Date	Closing Price	Rating	Price Target
02-Nov-06	39.10		48.00
27-Apr-06	36.95		42.00
20-Apr-06	35.10		39.00
19-Jan-06	32.40		36.00
20-Oct-05	25.96		33.00
20-Oct-05	25.96	1 -Overweight	
26-Aug-04	19.93		0.00

Date	Closing Price	Rating	Price Target
13-Jul-04	22.66		31.00
13-Jul-04	22.66	1 -Overweight	
25-Jun-04	23.92		30.00
22-Apr-04	29.43		29.00
19-Apr-04	28.22		27.00
22-Jan-04	28.42		28.00

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**Valuation Methodology:** Price target of \$44 is based on assumed P/E multiple of 19x our FY08 EPS of \$2.30.

**Risks Which May Impede the Achievement of the Price Target:** Amdocs, Ltd. derived 96% of FY03 total revenue from the telecommunications industry. The current financial and operating instability of many U.S. telecommunications companies could further threaten the visibility of Amdocs' future revenue, profits, and cash flow.

**Important Disclosures Continued:**

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Company Name	Ticker	Price (17-Jan-2007)	Stock / Sector Rating
Amdocs Ltd.	DOX	US\$ 34.44	1-Overweight / 2-Neutral

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