

Tata Consultancy Services

STOCK INFO. BLOOMBERG
BSE SENSEX: 8,541 TCS IN
REUTERS CODE
S&P CNX: 2,590 TCS.BO

11 October 2005

Buy

Rs1,468

Previous Recommendation: Buy

Equity Shares (m)	480.1
32-Week Range	1,505/1,017
1,3,12 Rel. Perf. (%)	-2/-26/-15
M.Cap. (Rs b)	704.8
M.Cap. (US\$ b)	15.7

YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
3/05A	97,272	20,521	49.2	46.0	29.8	19.4	71.9	84.8	7.2	24.6
3/06E	120,809	27,840	58.0	17.8	25.3	12.2	58.9	70.3	5.7	19.6
3/07E	151,600	33,751	70.3	21.2	20.9	8.3	47.1	55.6	4.5	15.7

- ✍ TCS has reported revenues of Rs29.5b, up by 8.9% QoQ (in line with estimates), backed by strong volume growth of 6.9% QoQ, and coupled with a 2% QoQ improvement in pricing. BFSI and Manufacturing bounced back with strong double-digit growth, while Telecom grew by 8.9% QoQ.
- ✍ The top client grew 26.4% QoQ, while the top 2-5 clients declined 6.8% QoQ and the top 6-10 clients grew 9.1% QoQ. The company had a net employee addition of 4,224 during the quarter.
- ✍ Cost of revenue increased by 200bp during the quarter due to the alignment of US onsite salaries, which was compensated by 130bp decline in SG&A expenses. Consequently, the EBITDA margin was down by 60bp.
- ✍ Net profit at Rs6.7b grew 8.8% QoQ. This was marginally higher than our estimate due to higher other income at Rs170m (up 73% QoQ), and lower minority interest outgo at Rs43m (down 48% QoQ).
- ✍ The 2QFY06 results for TCS were broadly in line with our estimates, except for the disappointment at the margins and higher other income. The growth momentum continues to be broad-based, with the key verticals picking up and the new services line gaining traction. Employee addition plans are also encouraging and margins seem to be set for improvement. We expect the volume growth to sustain momentum and remain positive on the stock. We expect earnings to grow by 35.7% in FY06 and by 21.2% in FY07. On our expected EPS of Rs70.3 for FY07, the stock is trading at PE of 20.9x. We maintain **Buy** with a target price of Rs1,547.

QUARTERLY PERFORMANCE

(Rs Million)

Y/E MARCH	FY 05				FY 06				FY 05	FY 06E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Revenues	21,335	24,307	25,784	25,846	27,094	29,513	31,057	33,145	97,272	120,809
Q-o-Q Change (%)	4.7	13.9	6.1	0.2	4.8	8.9	5.2	6.7	36.6	24.2
Direct Expenses	11,345	13,160	13,276	13,324	13,621	15,429	15,837	16,996	51,105	61,882
Sales, General & Admin. Expenses	3,673	4,017	4,768	5,203	5,515	5,573	5,932	6,457	17,662	23,477
Operating Profit	6,317	7,129	7,740	7,318	7,958	8,511	9,288	9,693	28,505	35,450
Margins (%)	29.6	29.3	30.0	28.3	29.4	28.8	29.9	29.2	29.3	29.3
Other Income	138	-8	1,041	-414	98	170	120	100	757	489
Depreciation	329	357	382	509	540	590	652	696	1,577	2,478
PBT bef. Extra-ordinary	6,126	6,764	8,398	6,396	7,517	8,091	8,756	9,096	27,685	33,461
Provision for Tax	1,002	946	1,283	834	1,247	1,317	1,401	1,446	4,065	5,411
Rate (%)	16.4	14.0	15.3	13.0	16.6	16.3	16.0	15.9	14.7	16.2
Minority interest	78	50	49	-116	83	43	42	41	61	209
Net Income bef. Extra-ordinary	5,047	5,769	7,066	5,677	6,187	6,731	7,313	7,609	23,559	27,840
Q-o-Q Change (%)	7.4	14.3	22.5	-19.7	9.0	8.8	8.7	4.0	46.1	18.2
PAT bef. Extra-ordinary	4,807	3,433	6,834	5,448	6,187	6,731	7,313	7,609	20,521	27,840

E: Inquire Estimates

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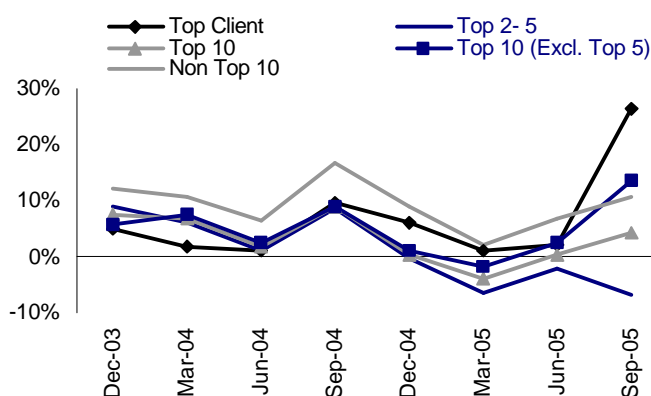
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Large clients amplify volume growth

TCS maintained strong momentum in its business in 2QFY06 with a volume growth of 7% QoQ. The top client grew 26.4% QoQ, while the top 2-5 clients declined 6.8% QoQ and the top 6-10 clients grew 9.1% QoQ. The quarter also saw the commencement of revenue inflow from ABN Amro, but the impact on the topline was marginal. Revenue inflow from Tata Tele Services has also commenced during the quarter, adding to the number of large deals serviced by the company. The ABN Amro deal, which was bagged during the quarter, is valued at €200m over a period of 5 years, while the Tata Tele Services is estimated at US\$250m over the next 5 years. The company has also signed a US\$15m development deal with ABN Amro, in addition to the maintenance and support contract, which is expected to start in 2HFY06.

The Top 2-5 clients continued to display a downward trend, with a 6.8% sequential decline. The company has stated that the decline is due to increased offshore transition in these accounts. However, further decline in these clients could negatively impact revenue growth, especially if the company is unable to sustain the high growth exhibited in its top client.

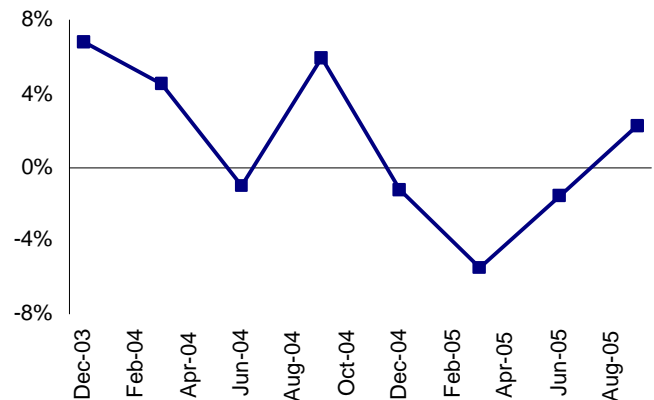
REVENUE GROWTH FROM CLIENTS



Source: Company/Motilal Oswal Securities

GE as a percentage of revenue continued to decline, ending the quarter at 12.3% of overall revenue. However, GE grew 2.3% in absolute terms after 3 successive quarters of negative growth. The broad-based growth in top clients has boosted growth in 2QFY06.

GE REVENUE GROWTH



Source: Company/Motilal Oswal Securities

TCS added 74 clients during the quarter, and the client churn nearly doubled from 37 in 1QFY06 to 71 in 2QFY06. The churn is similar to that witnessed by the other Tier I vendors in the Indian IT services space, and is expected to result in sustainability of revenue growth and better profitability.

Margins drop due to salary restructuring

The company restructured the onsite salaries in US and Australia, which resulted in 200bp increase in cost of revenue in 2QFY06. However, the net erosion in EBITDA margin was limited to 60bp due to 130bp decline in SG&A expenses, caused by reduction in travel, branding and advertising expenditure. SG&A expense thereby reduced to 18.9% of sales as opposed to 20.4% in 1QFY06. The company believes that the current level of SG&A expenditure is sustainable. The commencement of the big deals such as Tata Tele services and ABN Amro is expected to depress margins during 2HFY06, though the margins are expected to even out to the company average over the period of the individual contracts. However, given that the salary restructuring is complete, billing rates are stable with a positive bias and SG&A has been contained, we expect that margins would improve in the second half of FY06.

Net profit boosted by higher other income

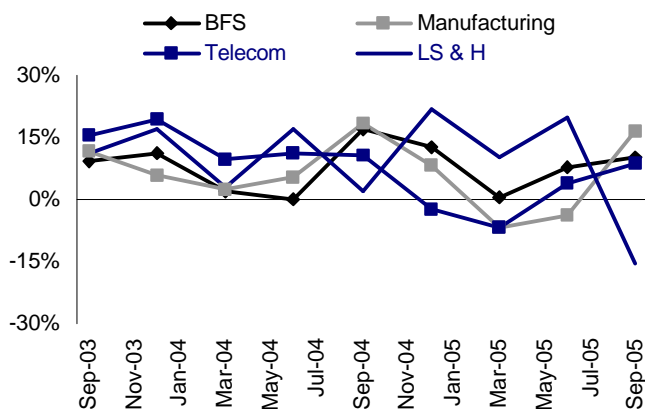
The net profit for the quarter was up 8.8% QoQ, with higher other income at Rs170m, which helped compensate the decline in profit due to the erosion in margins. The minority interest outgo was also lower in 2QFY06 at Rs43.2m as against Rs85.3m in 1QFY06, which also added to profit

growth. The company has forward cover to the tune of US\$300m, and expects a currency gain or loss to the tune of Rs100m from currency options in 3QFY06, depending on the rupee-dollar exchange rates during the next 3 months.

BFSI, Manufacturing and Telecom report strong growth

The company's top three verticals – BFSI, Manufacturing and Telecom reported robust growth, with manufacturing, which had declined in 4QFY05 and 1QFY06, growing 16.6% on a sequential basis. BFSI grew 10.3% QoQ, while Telecom grew 8.9% QoQ. Life sciences and healthcare was the only domain that saw a decline, revenue from the vertical declined 15.5% sequentially. We expect that BFSI, Manufacturing and Telecom would continue to report strong growth, with the commencement of multi-million dollar deals over the next 2 quarters.

REVENUE GROWTH IN VERTICALS



Source: Company/Motilal Oswal Securities

Employee addition remains robust

TCS added 5,596 employees (gross) during the quarter, while the net addition was 4,224. The company has planned for an attrition rate of 9% for the full year (attrition has increased from 8% in 1QFY06 to 8.2% in 2QFY06), and is targeting a net addition of 13,500 for FY06. The company

GROWTH BY SERVICE OFFERING

	SEP-03	DEC-03	MAR-04	JUN-04	SEP-04	DEC-04	MAR-05	JUN-05	SEP-05
ADM	12.4	10.4	9.8	-0.8	13.0	4.3	0.8	4.1	6.4
Enterprise Solution & PI	2.9	11.9	-1.4	31.5	16.0	4.2	-6.0	9.7	17.5
Asset Leveraged Solutions	31.1	-6.7	24.1	-7.9	34.6	6.1	20.3	0.8	-2.0
Others	29.4	10.2	196.4	-0.8	7.6	99.7	14.6	-5.5	18.8

Source: Company/Motilal Oswal Securities

has planned a net addition of 3,500 employees in 3QFY06 on an organic basis. Attrition rate is higher at the middle level for high demand skills such as SAP and SIEBEL. We believe that this could put pressure on the gross margins as the company tries to offer special incentives to employees with those skill sets in a bid to retain them. However, this would be offset by greater fresher composition at 50% of the total recruitment this year, which would ease pressures on the gross margin.

New service offerings gain traction

TCS remains focused on driving growth in the core IT services business, with Consulting, Technology Services and Asset based offerings acting as value drivers (higher margin businesses) and ITES and ISM acting as growth drivers (high volume generators). In 2QFY06, both the core ADM services and the newer businesses have shown good traction, with Enterprise Solutions driving growth across the Manufacturing, Pharma and Retails verticals. BPO, Consulting, Assurance Services and Infrastructure Management have added 8, 10, 6 and 18 clients respectively during the quarter and bagging significant deals. We believe that the “value drivers” would grow faster than company average, fuel growth across domains, and complement the core IT services business.

Valuation and view

The 2QFY06 results for TCS were broadly in line with our estimates, except for the disappointment at the margins and higher other income. The growth momentum continues to be broad-based with the key verticals picking up and the new services line gaining traction. Employee addition plans are also encouraging and margins seem to be set for improvement. We expect the volume growth to sustain momentum and remain positive on the stock. . We expect earnings to grow by 35.7% in FY06 and by 21.2% in FY07. On our expected EPS of Rs70.3 for FY07, the stock is trading at PE of 20.9x. We maintain **Buy** with a target price of Rs1,547.

KEY METRICS

	2Q FY06	% CHG QOQ	% CHG YOY	1Q FY06	2Q FY05
Revenue - IT Services					
Onsite (Rs m)	18,564	14.7	39.9	16,182	13,267
Onsite (%)	62.9			63.2	62.5
Offshore (Rs m)	10,950	16.2	37.6	9,422	7,960
Offshore (%)	37.1			36.8	37.5
Utilization					
Blended	75.0			74.8	76.9
Employee Base					
Employees	47,916			43,682	36,696
Gross Additions	5,596			3,913	4,769
Net Additions	4,224			2,690	3,974
Attrition Rate (%)	8.2			8.2	7.9
Client Performance					
Active Clients	624			553	490
Client Additions	74			68	52
Repeat Business	96.5			98.5	96.1
Client Concentration					
GE (Rs m)	3,630	2.3	-6.1	3,549	3,865
GE (%)	12.3			13.1	15.9
Top Client (Rs m)	1,712	26.4	38.1	1,355	1,240
Top Client (%)	5.8			5.0	5.1
Top 2-5 Clients (Rs m)	3,335	-6.8	-14.8	3,576	3,913
Top 5 Clients (%)	17.1			18.2	21.2
Top 6- 10 Clients (Rs m)	3,217	7.9	6.7	2,980	3,014
Top 10 Clients (%)	28.0			29.2	33.6
Remain. Clients (Rs m)	21,250	10.8	31.7	19,183	16,140
Remaining Clients (%)	72.0			70.8	66.4
Client Evaluation					
> US\$1m	233.0			219.0	177.0
> US\$5m	84.0			79.0	65.0
> US\$10m	50.0			45.0	34.0
> US\$20m	29.0			27.0	19.0
> US\$50m	5.0			5.0	5.0
Revenue by Project Type					
Fixed Price (Rs m)	0	-100.0	-100.0	9,079	8,134
Fixed Price (%)	49.3			47.9	49.1
Time & Material (Rs m)	0	-100.0	-100.0	9,875	8,432
Time & Material (%)	50.7			52.1	50.9

	2Q FY06	% CHG QOQ	% CHG YOY	1Q FY06	2Q FY05
Revenue by Domain					
Banking & FS (Rs m)	12,189	10.3	34.4	11,054	9,067
BFSI (%)	41.3			40.8	37.3
Manufacturing (Rs m)	5,401	16.6	13.4	4,633	4,764
Manufacturing (%)	18.3			17.1	19.6
Telecom (Rs m)	4,309	8.9	2.5	3,956	4,205
Telecom (%)	14.6			14.6	17.3
Life Sci. & Health. (Rs m)	1,122	-15.5	35.7	1,328	826
Life Sci. & Health. (%)	3.8			4.9	3.4
Retail & Distrib. (Rs m)	2,007	1.5	21.4	1,978	1,653
Retail & Distribution (%)	6.8			7.3	6.8
Retailing (Rs m)	1,062	3.2	6.6	1,030	997
Transportation (%)	3.6			3.8	4.1
Energy & Utilities (Rs m)	767	18.0	1.8	650	754
Energy & Utilities (%)	2.6			2.4	3.1
Others (Rs m)	2,656	7.7	41.9	2,466	1,872
Others (%)	9.0			9.1	7.7
Revenue by Geography					
North America (Rs m)	17,620	10.2	21.3	15,986	14,521
North America (%)	59.7			59.0	59.7
Europe (Rs m)	6,434	1.0	16.1	6,367	5,540
Europe (%)	21.8			23.5	22.8
India (Rs m)	3,719	17.3	30.5	3,170	2,849
India (%)	12.6			11.7	11.7
RoW (Rs m)	1,741	10.8	24.8	1,571	1,395
RoW (%)	5.9			5.8	5.7
Revenue by Service Offering					
ADM (Rs m)	20,748	6.4	16.5	19,508	17,817
ADM (%)	70.3			72.0	73.3
Enter.Solutions,PI (Rs m)	6,906	17.5	26.3	5,879	5,469
Enter.Solutions, PI (%)	23.4			21.7	22.5
Asset Lever. Sol. (Rs m)	797	-2.0	26.1	813	632
Asset Lever. Sol. (%)	2.7			3.0	2.6
Others (Rs m)	1,062	18.8	157.1	894	413
Others (%)	3.6			3.3	1.7

Source: Motilal Oswal Securities

Tata Consultancy Services: an investment profile

Company description

TCS is the largest IT services company in India with revenues of US\$2.2b in FY05 and employing nearly 50,000 people, providing IT as well as BPO services to more than 400 clients. It is the preferred vendor for a majority of the Fortune 500/Global 1000 companies. Its top clients include GE, Prudential, AIG, Target, P&O Nedlloyd and Standard Chartered.

Key investment arguments

- Experience of handling multi-million dollar contracts places it suitably against global players
- Client diversification, leading to narrowing the gap in growth differential compared to peers
- Volume growth could surprise due to more reliance on lateral recruitment, which happens just in time

Key investment risks

- Most vulnerable to salary inflation, as average salary per employee is lower compared to peers
- Lowering of experience profile could impact quality, as TCS is used to delivering services with more experienced people
- Inclination to accept complete IT outsourcing deals could impact profitability and return ratios

Recent developments

- Won a landmark deal from ABN Amro valued at €200m for application maintenance and support, to be executed over a period of 5 years
- Won a US\$250m from Tata Tele Services for IT infrastructure management, to be executed over a period of 5 years.

Valuation and view

- Revenue growth of 24.2% and EPS growth of 17.8% in FY06
- Valuations at 20.9x FY06E earnings reasonable, given strong growth and likely revenues of US\$3b in FY06
- Maintain **Buy** with a target price of Rs1,547, based on assigning a P/E of 22x FY07 earnings

Sector view

- Various CIO surveys indicate increasing share of offshore spending in IT budgets
- Indian offshore vendors gaining market share in competition with MNCs
- Prefer large companies as bulk of volumes going to them while niche players benefit due to lack of offshore competition

COMPARATIVE VALUATIONS

		TCS	INFOSYS	WIPRO
P/E (x)	FY06E	25.3	28.9	29.4
	FY07E	20.9	22.9	23.0
P/B (x)	FY06E	12.2	10.2	7.4
	FY07E	8.3	7.8	5.5
EV/Sales (x)	FY06E	5.7	7.1	4.9
	FY07E	4.5	5.2	3.7
EV/EBITDA (x)	FY06E	19.6	21.9	20.6
	FY07E	15.7	16.0	14.8

SHAREHOLDING PATTERN (%)

	JUN.05	MAR.05	JUN.04
Promoters	84.8	84.8	NA
Domestic Institutions	2.5	2.5	NA
FII's/FDIs	6.4	6.3	NA
Others	6.3	6.4	NA

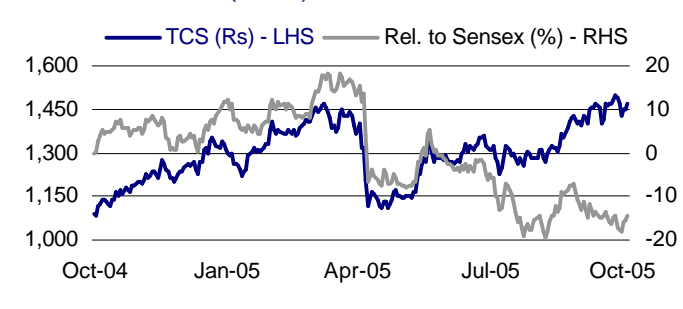
EPS: INQUIRE FORECAST VS CONSENSUS (RS)

	INQUIRE FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY06	58.0	61.6	-5.8
FY07	70.3	77.0	-8.7

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
1,468	1,547	5.4	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2003	2004	2005	2006 E	2007 E
Sales	55,179	71,227	97,272	120,809	151,600
Change (%)	26.2	29.1	36.6	24.2	25.5
Cost of Services	31,227	37,706	51,105	61,882	78,499
SG&A Expenses	10,489	14,093	17,662	23,477	29,957
EBITDA	13,463	19,429	28,505	35,450	43,143
% of Net Sales	24.4	27.3	29.3	29.3	28.5
Depreciation	1,039	1,331	1,577	2,478	3,684
Other Income	780	937	757	489	538
PBT	13,204	19,034	27,685	33,461	39,996
Tax	2,445	2,884	4,065	5,411	6,054
Rate (%)	18.5	15.2	14.7	16.2	15.1
PAT	10,759	16,150	23,620	28,049	33,942
Minority Interest	79	125	79	215	191
Extraordinary	48	100	-3,020	6	0
Net Income	10,728	16,125	20,521	27,840	33,751
Change (%)	-2.8	50.3	27.3	35.7	21.2

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2003	2004	2005	2006 E	2007 E
Share Capital	456	456	481	481	481
Share Premium	0	0	0	0	0
Reserves	12,786	20,096	36,000	57,576	84,578
Net Worth	13,242	20,552	36,481	58,057	85,059
Minority Interest	1,123	26	25	25	25
Loans	7,240	7,568	0	0	0
Capital Employed	21,950	28,480	36,833	58,402	85,399
Gross Block	10,737	13,052	17,052	27,052	39,052
Less : Depreciation	5,773	6,306	7,862	10,278	14,826
Net Block	4,964	6,747	9,191	16,774	24,226
CWIP	326	220	220	220	221
Other LT Assets	2,072	1,677	1,826	1,990	2,170
Investments	210	66	0	0	0
Curr. Assets	28,567	28,662	38,946	56,812	79,185
Debtors	14,170	13,838	18,655	23,831	28,243
Cash & Bank Balance	1,332	1,571	3,812	12,957	26,601
Loans & Advances	2,243	2,266	0	0	0
Other Current Assets	10,822	10,986	16,479	20,024	24,340
Current Liab. & Prov	14,189	8,892	13,350	17,394	20,404
Creditors	2,358	1,922	2,826	4,677	5,943
Other liabilities	11,831	6,970	10,524	12,717	14,460
Net Current Assets	14,378	19,770	25,596	39,418	58,781
Application of Funds	21,950	28,480	36,833	58,402	85,399

E: Inquire Estimates

RATIOS					
Y/E MARCH	2003	2004	2005	2006 E	2007 E
Basic (Rs)					
EPS	22.3	33.7	49.2	58.0	70.3
Cash EPS	24.5	36.3	45.9	63.0	77.8
Book Value	27.5	42.7	75.8	120.7	176.8
DPS	0.0	0.0	8.5	11.6	14.0
Payout %(Incl.Div.Taxes)	0.0	0.0	20.0	20.0	20.0
Valuation (x)					
P/E		43.5	29.8	25.3	20.9
Cash P/E		40.4	32.0	23.3	18.9
EV/EBITDA		36.6	24.6	19.6	15.7
EV/Sales		10.0	7.2	5.7	4.5
Price/Book Value		34.4	19.4	12.2	8.3
Dividend Yield (%)		0.0	0.6	0.8	1.0
Profitability Ratios (%)					
RoE	79.6	92.3	71.9	58.9	47.1
RoCE	66.4	75.5	84.8	70.3	55.6
Turnover Ratios					
Debtors (Days)	94	71	70	72	68
Fixed Asset Turnover (x)	5.1	5.5	5.7	4.5	3.9
Leverage Ratio					
Debt/Equity Ratio(x)	0.5	0.4	0.0	0.0	0.0

CASH FLOW STATEMENT					
(Rs Million)					
Y/E MARCH	2003	2004	2005	2006 E	2007 E
CF from Operations	11,767	17,456	26,693	32,735	41,985
Cash for Working Capital	5,233	4,240	8,208	7,163	9,352
Net Operating CF	6,534	13,216	18,485	25,572	32,632
Net Purchase of FA	-1,379	-2,321	-4,150	-10,164	-12,179
Net Purchase of Invest.	41	144	66	0	0
Net Cash from Invest.	-1,338	-2,178	-4,084	-10,164	-12,179
Proceeds from Pvt. Place.	0	0	25	0	0
Proceeds from LTB/STB	3,309	328	-7,568	0	0
Net Cash withdrawn by Tata :	-9,121	-11,128	0	0	0
Dividend Payments	0	0	-4,617	-6,264	-6,751
Cash Flow from Fin.	-5,812	-10,800	-12,161	-6,264	-6,751
Free Cash Flow	5,155	10,895	14,335	15,408	20,453
Net Cash Flow	-616	239	2,240	9,144	13,702
Opening Cash Balance	1,948	1,332	1,571	3,812	12,957
Add: Net Cash	-616	239	2,240	9,144	13,702
Closing Cash Balance	1,332	1,571	3,812	12,957	26,601

N O T E S

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