



Tata Consultancy Services

STOCK INFO.	BLOOMBERG
BSE SENSEX: 14,115	TCS IN
	REUTERS CODE
S&P CNX: 4,077	TCS.BO
Equity Shares (m)	978.6
52-Week Range	1,399/728
1,6,12 Rel. Perf. (%)	10/6/14
M.Cap. (Rs b)	1,299.4
M.Cap. (US\$ b)	29.4

16 January 2007

Buy

Previous Recommendation: Buy

Rs1,328

YEAR END	NET SALES (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
3/06A*	132,550	28,968	29.8	21.2	44.5	22.2	62.1	69.9	9.7	34.8
3/07E*	186,889	41,505	42.4	42.1	31.3	14.4	54.3	61.0	6.8	24.9
3/08E	245,206	53,807	55.0	29.6	24.1	9.9	47.2	54.4	5.1	18.7

* 1:1 bonus in FY07, accordingly ratios are adjusted

Higher realizations and productivity gains help beat revenue, margin expectations: TCS registered 8.4% QoQ growth in revenue to Rs48.6b. Realizations improved 2% in Time and Material (T&M) contracts, and productivity gains in fixed price projects added 2.6% to revenue growth. PAT of Rs11b was higher than our expectation of Rs10.7b, driven by higher EBITDA margins of 28.3% v/s our expectation of 27.6%.

Product business visibility to emerge as additional margin lever: Products grew 21.5% QoQ – the company has recently signed a US\$100m deal for its core banking software, for which license fee revenue is yet to be fully booked. TCS is currently pursuing new deals worth US\$50-100m in this space, which would significantly add to product revenue visibility, as its current run rate is just above US\$120m per year.

Sufficient margin levers exist, but 200bp QoQ improvement seems to be a tall order: TCS has registered 26.8% EBITDA margins for 9MFY07. It has now guided that for FY07, EBITDA margins will be near FY06 levels. To attain FY06 margins, TCS needs to ensure a 200bp margin expansion in 4QFY07, which appears steep. However, we believe that any significant license revenue booking in 4QFY07 could lead to considerable margin improvement.

We reiterate our Buy recommendation: Considering the better than expected performance in 3QFY07 and better visibility in product revenues going forward, we are revising our EPS estimates by 1.8% to Rs42.4 for FY07, by 3.3% to Rs55 for FY08 and by 3.5% to Rs66.6 for FY09. The stock trades at 24.1x FY08E and 19.9x FY09E EPS. **Buy** with a price target of Rs1,535 (23x FY09E EPS), a 15.6% upside.

QUARTERLY PERFORMANCE

(Rs Million)

Y/E MARCH	FY06				FY07*				FY06*	FY07E*
	1Q	2Q	3Q*	4Q*	1Q*	2Q*	3Q*	4QE*		
Revenues	27,094	29,513	34,527	37,234	41,443	44,822	48,605	52,019	132,550	186,889
Q-o-Q Change (%)	4.8	8.9	17.0	7.8	11.3	8.2	8.4	7.0	36.3	41.0
Direct Expenses	13,621	15,428	18,064	19,897	22,989	23,880	25,758	27,183	69,746	99,810
Sales, General & Admin. Expenses	5,515	5,573	6,696	7,507	8,327	8,648	9,094	9,832	25,797	35,900
Operating Profit	7,958	8,513	9,767	9,830	10,128	12,294	13,753	15,004	37,008	51,179
Margins (%)	29.4	28.8	28.3	26.4	24.4	27.4	28.3	28.8	27.9	27.4
Other Income	98	170	-154	-40	668	77	300	250	257	1,295
Depreciation	540	592	738	865	863	958	1,080	1,248	2,806	4,149
PBT bef. Extra-ordinary	7,517	8,091	8,875	8,919	9,932	11,414	12,973	14,006	34,459	48,324
Provision for Tax	1,247	1,317	1,319	898	1,238	1,447	1,828	1,961	4,984	6,473
Rate (%)	16.6	16.3	14.9	10.1	12.5	12.7	14.1	14.0	14.5	13.4
Minority Interest	83	43	45	70	69	52	98	128	280	346
Net Income bef. Extra-ordinary	6,187	6,731	7,511	7,951	8,626	9,915	11,047	11,918	29,211	41,505
Q-o-Q Change (%)	9.0	8.8	11.6	5.9	8.5	14.9	11.4	7.9	29.6	42.1
PAT aft Extra-ordinary	6,187	6,731	7,511	7,725	8,626	9,915	11,047	11,918	28,968	41,505

*Consolidated numbers that include Tata Infotech

Higher realizations and productivity gains help beat revenue, margin expectations

TCS registered 8.4% QoQ growth in revenue to Rs48.6b (v/s our estimate of 6.5% QoQ growth; in dollar terms revenue growth was 12.6%). Volumes grew 7.9% QoQ, while realizations improved 2% in T&M contracts. TCS also witnessed 2.6% increase in revenue through productivity gains in fixed price projects. However, there was negative impact of 1.6% on revenue growth due to shift to offshore (up to 41.6% from 41% in 2QFY07). We also believe that some revenue growth can be attributed to consolidation of TKS Teknosoft from mid-3QFY07 (registered revenues of US\$57m in CY05).

PAT of Rs11b (up 11.4% QoQ) was higher than our expectation of Rs10.7b, driven by higher EBITDA margins of 28.3% v/s our expectation of 27.6%. This is despite the 170bp impact of Rupee appreciation on 3QFY07 margins as well absence of 100bp positive impact due to write-back of provident fund expenses in 2QFY07. Improvement in 3QFY07 was largely driven by: (1) better pricing realizations (174bp impact); (2) increase in offshore contribution by 60bp (30bp impact); (3) productivity gains in fixed price projects; and (4) SG&A leverage. However, higher write-back of bad debts and lower provision for client claims in subsidiaries resulted in further 20bp improvement in margins. Higher than expected other income at Rs300m (v/s our estimate of Rs200m) also contributed to higher profit growth.

KEY VERTICALS CONTINUE TO DELIVER STRONG GROWTH (%)

	DEC-05	MAR-06	JUN-06	SEP-06	DEC-06
Verticals					
BFSI	18.4	7.8	9.7	12.1	10.5
Manufacturing	13.2	-0.1	8.6	3.4	7.7
Telecom	23.4	0.1	28.4	8.8	9.7
Life Sci. and Healthcare	32.4	12.9	1.4	5.5	22.0
Retail and Distribution	6.7	11.3	16.5	6.5	13.4
Transportation	0.7	28.7	8.3	2.1	-7.5
Energy and Utilities	3.5	40.7	-3.5	12.3	-11.6
Others	19.6	16.0	4.6	1.2	-0.3

Source: Company/Motilal Oswal Securities

Large deal emphasis to drive volume growth, pricing continues to be favorable

In 3QFY07, TCS has won 2 large deals of more than US\$100m, 1 large deal of US\$100m and 2 large deals of around US\$70m. It is currently pursuing 10 large deals (of more than US\$50m), which are likely to be closed in the following quarters, indicating robust sales visibility and no slowdown in spending and offshoring. In the past, TCS has been aggressive in its large deal strategy and we expect TCS to continue to pursue large deals, which would accelerate volume growth over the coming quarters. According to TPI, 15.1% of the 73 active deals in the pipeline as on 31 December 2006 are expected to be awarded to Indian IT vendors, up from 14.3% as on 30 September 2006. We believe that TCS can leverage its considerable near shore presence along with its domain capabilities and bag significant deals in this space.

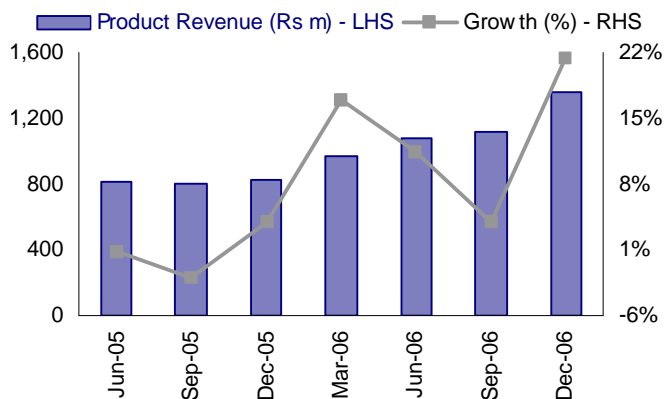
On the pricing front, TCS continues to claim that is able to get 5-10% higher realizations for new contracts and 3-5% higher pricing for renewals, which could aid margins going forward. We expect improvement in price realizations to also accrue on account of better service mix due to faster growth in high margin services and improvement in service mix of Tata Infotech and CMC.

Product business visibility to emerge as additional margin lever

Asset leveraged solutions (product business) grew 21.5% QoQ in 3QFY07 – the company has recently signed a US\$100m deal with a Chinese bank for its core banking software, for which license fee revenue is yet to be fully booked (any significant booking in 4QFY07 will lead to margin improvement). TCS is currently pursuing new deal worth US\$50-100m in this space, which would significantly add to product revenue visibility, as its current run rate is just above US\$120m p.a. A significant chunk of the license fees could be booked over the next 2-3 quarters, which

would also contribute to margin improvement. Considering the two large deal wins by TCS/FNS in the core banking side and the company's healthy pipeline, contribution of products should continue to increase, resulting in margin expansion.

INCREASING PRODUCT REVENUE TO AID MARGIN EXPANSION



Source: Company/Motilal Oswal Securities

Sufficient margin levers exist, but 200bp QoQ improvement seems to be a tall order

In addition to product composition, TCS also has other margin levers: (1) offshore composition is currently low at 41.6%; (2) profitability improvement in Diligenta (at single digits in 9MFY07); (3) expected improvement in price realizations; and (4) improvement in service mix in Tata Infotech and CMC. TCS has registered 26.8% EBITDA margins for 9MFY07 and it has now guided that for FY07, EBITDA margins will be near FY06 levels of 27.9%. To attain FY06 margins, TCS needs to register nearly 200bp expansion in 4QFY07 margins, which looks steep. However, we believe that any significant license revenue booking in 4QFY07 from large deals won in the product space would lead to considerable margin improvement.

We reiterate our Buy recommendation

Considering the better than expected performance in 3QFY07 and better visibility in product revenues going forward, we are revising our EPS estimates by 1.8% to Rs42.4 for FY07, by 3.3% to Rs55 for FY08 and by 3.5% to Rs66.6 for FY09. The stock trades at 24.1x FY08E and 19.9x FY09E EPS. **Buy** with a price target of Rs1,535 (23x FY09E EPS), a 15.6% upside.

Tata Consultancy Services: an investment profile

Company description

TCS is the largest IT services company in India, with revenue of around US\$3b in FY06. It employs 83,500 people, and provides IT as well as BPO services to more than 750 clients. It is the preferred vendor for a majority of the Fortune 500/Global 1,000 companies. Its top clients include GE, Prudential, AIG, Target, P&O Nedlloyd, ABN Amro and Standard Chartered.

Key investment arguments

- ✎ Experience of handling multi-million dollar contracts places it suitably against global players.
- ✎ Client diversification, leading to narrowing gap in growth differential compared to peers.
- ✎ Has considerable near shore presence, could give a competitive edge in bagging clients who are new to offshoring.

Key investment risks

- ✎ Lowering of experience profile could impact quality, as TCS is used to delivering services with more experienced people.
- ✎ Inclination to accept large complete IT outsourcing deals could impact profitability and return ratios.

Recent developments

- ✎ Won a 5-year, US\$140m deal from a leading Latin American bank, as part of which it will implement FNS BANCS core banking solution.
- ✎ Won a US\$100m deal for TCS-FNS with a leading Chinese bank.

Valuation and view

- ✎ Revenue CAGR of 36% and PAT CAGR of 35.7% over FY06-08.
- ✎ Valuations at 19.9x FY09E earnings offer room for upside, given strong growth and higher earnings visibility.
- ✎ Maintain **Buy** with a target price of Rs1,535.

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; niche players benefit due to lack of offshore competition.

COMPARATIVE VALUATIONS

		TCS	INFOSYS	WIPRO
P/E (x)	FY07E	31.3	33.1	32.9
	FY08E	24.1	25.5	25.4
P/BV (x)	FY07E	14.4	12.1	8.9
	FY08E	9.9	8.8	6.8
EV/Sales (x)	FY07E	6.8	8.5	5.9
	FY08E	5.1	6.3	4.3
EV/EBITDA (x)	FY07E	24.9	26.7	25.9
	FY08E	18.7	20.0	18.8

SHAREHOLDING PATTERN (%)

	DEC.06	SEP.06	DEC.05
Promoters	82.5	83.6	83.9
Domestic Institutions	4.4	4.0	2.8
FII/Foreigners	7.0	5.9	7.9
Others	6.1	6.5	5.4

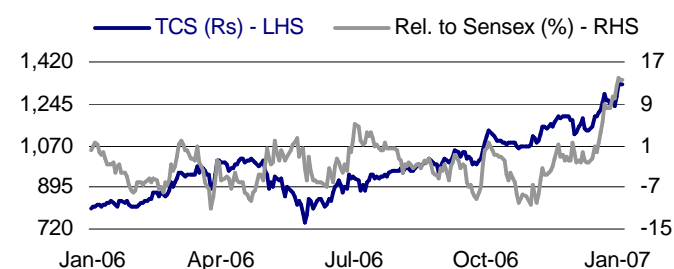
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	42.4	41.8	1.5
FY08	55.0	52.9	3.9

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
1,328	1,535	15.6	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Sales	97,272	132,550	186,889	245,206	307,581
Change (%)	36.6	36.3	41.0	31.2	25.4
Cost of Services	51,105	69,746	99,810	133,598	170,890
SG&A Expenses	17,662	25,797	35,900	45,242	55,646
EBITDA	28,505	37,008	51,179	66,366	81,046
% of Net Sales	29.3	27.9	27.4	27.1	26.3
Depreciation	1,577	2,806	4,149	5,027	6,305
Interest	0	0	0	0	0
Other Income	757	257	1,295	1,950	2,810
PBT	27,685	34,459	48,324	63,289	77,551
Tax	4,065	4,984	6,473	8,883	11,633
Rate (%)	14.7	14.5	13.4	14.0	15.0
Equity in net earnings of aff	18	16	58	100	144
Minority Interest	79	280	404	698	892
PAT	23,559	29,211	41,505	53,807	65,170
Extraordinary	-3,038	-243	0	0	0
Net Income	20,521	28,968	41,505	53,807	65,170
Change (%)	25.4	41.2	43.3	29.6	21.1

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Share Capital	480	489	979	979	979
Share Premium	0	0	0	0	0
Reserves	31,497	57,919	89,388	130,820	181,001
Net Worth	31,977	58,408	90,367	131,799	181,979
Minority Interest	1,323	1,564	2,667	3,366	4,258
Loans	1,928	979	500	250	0
Capital Employed	35,712	62,900	95,483	137,363	188,186
Gross Block	15,261	22,320	34,820	48,820	64,820
Less : Depreciation	5,360	9,951	14,101	19,127	25,433
Net Block	9,902	12,369	20,719	29,693	39,387
CWIP	968	2,703	2,501	3,001	3,001
Other LT Assets	3,164	13,868	19,098	22,003	22,529
Investments	4,183	7,086	15,000	30,000	50,000
Curr. Assets	30,692	49,600	71,460	103,611	138,859
Debtors	20,343	32,790	44,014	55,412	67,620
Cash & Bank Balance	2,633	3,965	8,053	26,398	44,442
Loans & Advances	0	0	0	0	0
Other Current Assets	7,717	12,845	19,393	21,802	26,796
Current Liab. & Prov	13,197	22,726	33,296	50,946	65,591
Creditors	2,727	4,308	5,932	7,504	9,350
Other liabilities	10,469	18,418	27,362	43,440	56,238
Net Current Assets	17,495	26,874	38,165	52,666	73,268
Application of Funds	35,712	62,900	95,483	137,362	188,185

E: MOST Estimates

* RATIOS					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Basic (Rs)					
EPS	24.6	29.8	42.4	55.0	66.6
Cash EPS	26.2	32.5	46.7	60.1	73.0
Book Value	33.3	59.7	92.3	134.7	186.0
DPS	4.2	6.8	9.8	12.6	15.3
Payout%(Incl.Div.Taxes)	20.0	22.8	23.0	23.0	23.0
Valuation (x)					
P/E		44.5	31.3	24.1	19.9
Cash P/E		40.9	28.5	22.1	18.2
EV/EBITDA		34.8	24.9	18.7	14.9
EV/Sales		9.7	6.8	5.1	3.9
Price/Book Value		22.2	14.4	9.9	7.1
Dividend Yield (%)		0.5	0.7	1.0	1.2
Profitability Ratios (%)					
RoE	80.4	62.1	54.3	47.2	40.6
RoCE	90.2	69.9	61.0	54.4	47.6
Turnover Ratios					
Debtors (Days)	76	90	86	82	80
Fixed Asset Turnover (x)	6.4	5.9	5.4	5.0	4.7
Leverage Ratio					
Debt/Equity Ratio(x)	0.1	0.0	0.0	0.0	0.0

* 1:1 bonus in FY07, accordingly ratios are adjusted

CASH FLOW STATEMENT					
(Rs Million)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
CF from Operations	24,046	31,953	46,491	59,872	72,755
Cash for Working Capital	-3,772	-7,098	-14,213	-942	-4,414
Net Operating CF	20,274	24,855	32,278	58,930	68,341
Net Purchase of FA	-3,909	-12,511	-12,298	-14,500	-16,000
Net Purchase of Invest.	-2,033	-2,074	-7,914	-15,000	-20,000
Net Cash from Invest.	-5,942	-14,585	-20,212	-29,500	-36,000
Inc./(Dec) in Equity & other	18,921	71	0	0	0
Proceeds from LTB/STB	-5,563	-1,193	-479	-250	-250
Net Cash withdrawn by Tat.	-23,000	0	0	0	0
Dividend Payments	-3,624	-7,960	-7,498	-10,835	-14,046
Cash Flow from Fin.	-13,265	-9,083	-7,978	-11,085	-14,296
Free Cash Flow	16,365	12,344	19,980	44,430	52,341
Net Cash Flow	1,067	1,187	4,088	18,345	18,045
Opening Cash Balance	1,566	2,778	3,965	8,053	26,398
Add: Net Cash	1,067	1,187	4,088	18,345	18,045
Closing Cash Balance	2,633	3,965	8,053	26,398	44,443



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Tata Consultancy Services

1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No

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