

Company Flash

15 October 2007 | 9 pages

Tata Consultancy Services (TCS.BO)

Buy: 2QFY08 Results – Ahead of Expectations

- 2QFY08 ahead of expectations** — TCS reported good 2QFY08 results – revenues grew 10.8% qoq to \$1.42b (our exp: \$1.38b) and EBITDA margins at 26.3% (exp: +26.1%) were up 80bp qoq. Net profit for Q2 was Rs12.15b (exp: Rs12b). Volumes in the international business were up 9% qoq.
- Hiring strong** — TCS hired ~9,300 employees in the quarter taking the consolidated headcount to ~104,000. Attrition remained stable at 11.5%. For FY09, TCS has made campus offers to ~22,300 graduates (compared to ~11,300 graduates at the end of same quarter last year).
- Pricing and offshore leverage drive margins** — TCS reported another quarter of pricing increase – realizations improved by ~85 bp qoq. Offshore proportion of revenues increased by ~190bp qoq. Pricing increase and higher offshore proportion resulted in margin expansion despite INR appreciation.
- No further clarity on CY08 IT budgets, as expected** — Management highlighted that North America and BFSI had grown ahead of the average and deal pipeline continued to look strong. However, there was no further clarity beyond TCS indicating that it continues to look at the environment and client base closely.
- Macro concerns remain; Tier I better placed** — Key investor concerns continue to be (1) INR appreciation and (2) clarity over 2008 IT budgets. Clarity on IT budgets should emerge in the next 2-3 months. Tier I companies are better placed in current environment. TCS trades at ~17x FY09E EPS.

Buy/Low Risk	1L
Price (15 Oct 07)	Rs1,073.65
Target price	Rs1,460.00
Expected share price return	36.0%
Expected dividend yield	1.3%
Expected total return	37.3%
Market Cap	Rs1,050,685M US\$26,824M

Price Performance (RIC: TCS.BO, BB: TCS IN)



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2006A	29,074	29.71	39.1	36.1	18.0	64.3	0.6
2007A	40,608	41.50	39.7	25.9	11.8	55.1	1.1
2008E	50,443	51.55	24.2	20.8	8.4	47.0	1.3
2009E	61,309	62.65	21.5	17.1	6.1	41.3	1.5
2010E	68,837	70.34	12.3	15.3	4.7	34.9	1.7

Source: Powered by dataCentral

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Other Key Highlights

- Forex gains of Rs.450m were included in the revenue line while Rs.577m was a part of other income.
- TCS management indicated 3-5% upward renegotiations in pricing on existing contracts and 5-8% increase in pricing on new contracts.
- In Q2YF08, TCS announced three \$50m deals out of which one was in BFSI. The three deals : (1) IT development/support contract from World's premier non-profit financial services firm (2) Multi-year contract with Chile's department of Justice Civil registry and (3) F&A BPO contract from a Telecom service provider in Iberoamerica.
- Transportation vertical witnessed a strong growth – 4.2% of revenues in Q2 as against 2.8% of revenues in Q1.
- At the end of Q2, TCS had ~\$2.6b outstanding in hedges.

Figure 1. Key financials

Rs mn	2Q07	1Q08	2Q08	QoQ	YoY
Revenue (US\$ m)	975	1,278	1,416	10.8%	45.1%
Revenue	44,822	52,028	56,398	8.4%	25.8%
Cost of revenue	24,487	29,077	31,106	7.0%	27.0%
Gross profit	20,335	22,951	25,293	10.2%	24.4%
Gross margin	45.4%	44.1%	44.8%	73bp	-52bp
Operating expenses	8,999	10,952	11,854	8.2%	31.7%
EBIT	11,336	11,999	13,439	12.0%	18.6%
EBIT margin	25.3%	23.1%	23.8%	77bp	-146bp
Depreciation and amortization	958	1,265	1,381	9.2%	44.2%
EBITDA	12,294	13,264	14,821	11.7%	20.6%
EBITDA margin	27.4%	25.5%	26.3%	78bp	-115bp
Other income	77	443	305	-31.3%	294.0%
Profit before tax	11,414	13,516	14,544	7.6%	27.4%
Income tax expense	-1,447	-1,523	-2,037	33.7%	40.8%
Income from operations	9,967	11,993	12,507	4.3%	25.5%
Affiliates/Minority	-52	-138	-38	-72.5%	-26.7%
Net income - recurring	9,915	11,855	12,469	5.2%	25.8%
EO income/(loss)	0	0	0	n.a.	n.a.
Net profit	9,915	11,855	12,469	5.2%	25.8%
EPS - basic & diluted	10.13	12.11	12.74	5.2%	25.7%

Source: Company Reports

Figure 2. Key HR and execution metrics

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08
TCS (Consolidated)	71,190	78,028	83,500	89,419	94,902	104,347
TCS Ltd.	67,530	74,193	79,755	85,582	91,094	100,362
Indian subsidiaries (Total)	3,660	3,835	3,745	3,837	3,808	3,985
Gross addition (Total)	7,095	8,919	7,835	8,613	8,706	12,523
Net addition (Total)	4,698	6,663	5,562	5,827	5,512	9,268
Trainees	2,574	3,764	2,478	3,843	2,898	5,899
Experienced	2,703	4,200	4,015	2,918	4,795	5,658
Execution matrices						
Attrition rate (%)	10.6%	10.6%	10.8%	11.3%	11.5%	11.5%
Utilization rate						
Including trainees	77.3%	75.2%	75.0%	74.7%	76.0%	73.7%
Excluding trainees	80.1%	79.4%	78.2%	79.6%	79.1%	78.9%

Source: Company Reports

Figure 3. Revenue mix

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08
Geographic Mix						
Americas	56.1%	57.0%	56.5%	55.3%	55.1%	56.4%
Europe	27.7%	28.5%	28.6%	29.0%	29.3%	28.3%
India	10.6%	8.4%	7.9%	9.4%	9.0%	8.2%
Others	5.6%	6.1%	7.0%	6.3%	6.6%	7.1%
Service Mix						
ADM & engineering services	66.9%	67.8%	68.4%	66.5%	66.4%	63.6%
Enterprise solutions & PI	23.0%	21.5%	20.7%	21.8%	21.1%	23.0%
Asset leverages solutions	2.6%	2.5%	2.8%	3.1%	3.3%	3.4%
Others	7.5%	8.2%	8.1%	8.6%	9.2%	10.0%
Vertical Mix						
BFSI	41.2%	42.7%	43.5%	41.3%	43.1%	43.3%
Manufacturing	16.0%	15.3%	15.2%	15.1%	12.4%	12.7%
Telecommunications	16.5%	16.6%	16.8%	17.6%	17.1%	17.8%
Life sciences & healthcare	4.1%	4.0%	4.5%	4.7%	6.1%	5.6%
Retail & distribution	6.7%	6.6%	6.9%	7.9%	8.0%	7.6%
Transportation	3.6%	3.4%	2.9%	3.2%	2.8%	4.4%
Energy & utilities	2.6%	2.7%	2.2%	2.3%	2.4%	2.5%
Others (media & entertainment and government)	9.3%	8.7%	8.0%	7.9%	8.1%	6.1%

Source: Company Reports

Figure 4. Key client metrics

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08
Total active clients	764	742	754	780	771	814
New clients	62	58	55	43	54	51
Client relationships						
>\$1 million	258	274	288	297	322	334
>\$5 million	97	105	114	119	126	139
>\$10 million	65	70	74	75	85	92
>\$20 million	33	32	37	39	45	51
>\$50 million	10	15	15	14	18	18
Client concentration						
Top client	4.0%	4.9%	5.7%	6.6%	6.8%	7.0%
Top 5 clients	16.7%	16.8%	17.4%	18.5%	19.0%	19.1%
Top 10 clients	26.8%	26.8%	27.5%	28.4%	29.3%	27.6%

Source: Company Reports

New services continue to ramp up fast and now contribute ~51% of revenues compared to 48% in Q1

Consulting, Assurance services and infrastructure services all grew 20%+ qoq in Q2

BFSI continued to see strong growth – grew ~12% qoq

Tata Consultancy Services

Company description

TCS is India's largest and among the oldest IT companies. It is part of the diversified Tata Group, one of the largest corporate groups in Asia. It has more than 83,500 employees, including its subsidiaries, with marketing presence across 32 countries and development presence in 10 countries besides India. It provides a comprehensive range of IT services to industries such as banking and financial services, insurance, manufacturing, telecommunications, retail and transportation. It had more than 780 active clients at end-4Q07, including six of the Fortune Top 10 companies in the US. The company started with data processing work in 1968, and was the first to provide offshore services in 1974. Over the last three decades, the company has come a long way with deep technical and project management expertise in handling complex client projects and strong offshore processes.

Investment strategy

We rate TCS as Buy/Low Risk (1L) based on a fundamental 12-month view. As India's largest and most experienced IT services firm, TCS looks well positioned to benefit from the growing demand for offshore IT services. It is a well-regarded stock among investors familiar with India and the IT-services sector. We believe TCS' margins in its international IT services business (around 95% of EBIT) are likely to trend down over the next few years. However, we expect this decline to be relatively modest, as we expect positive leverage from a better onsite-offshore mix, more hiring of fresh graduates, and improved utilization with a strong demand outlook to offset margin pressures from wage inflation. We expect a revenue CAGR of 25% and an EPS CAGR of 20% in FY07-10E.

Valuation

Our target price of Rs1,460 is based on a P/E of 24x FY09E EPS, derived from a 4% discount to our target 25x FY09E EPS for Infosys, TCS's closest peer on business model. We expect TCS to continue to trade at slightly lower multiples than Infosys due to its slower long-term growth and investors' greater comfort and familiarity with Infosys. Our target price assumes a one-year forward P/E of 40-50% above the average BSE Sensex multiple, which we think is justified given TCS' superior FCF, RoIC and growth rates than the overall market, and it actually implies a slightly lower premium than that for Infosys. We believe P/E remains the most appropriate valuation measure given TCS' profitable track record and strong earnings visibility.

Risks

We rate TCS as Low Risk, consistent with our quantitative stock-volatility based risk-rating system. Fundamentally also, given the stock's below-market beta, its relatively high earnings visibility, strong cash flows and balance sheet - along with our Low Risk rating for its local peers Infosys and Wipro - we believe a Low Risk rating for TCS is reasonable. The key downside risks that could impede the stock from reaching our target price include: (1) Any significant appreciation of the rupee against the US Dollar/Euro/GBP; (2) A sharp slowdown in the US economy; (3) H1B visa quotas; (4) Large exposure to the GE Group; (5) Large exposure to fixed-price contracts; (6) TCS's higher onsite

revenue contribution (~60% of total); and (7) Acquisition-related risks, including M&A with other Tata-group IT firms.

Appendix A-1

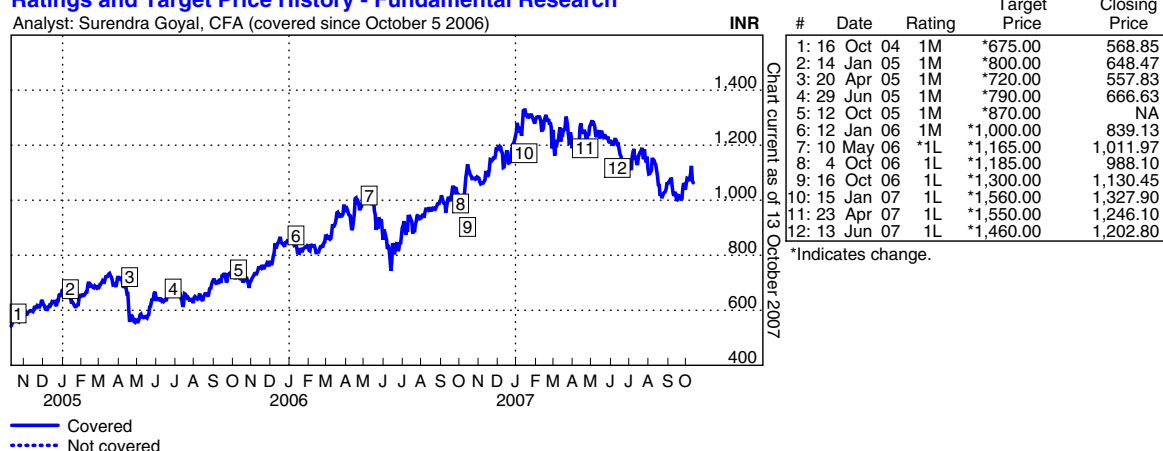
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Analyst: Surendra Goyal, CFA (covered since October 5 2006)



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