Company

17 June 2010 | 12 pages

Tata Consultancy Services (TCS.BO)

Equity

Hold: FY10 Annual Report Highlights

- **Strong volumes/offshore shift** — Revenue growth of ~8% YoY (INR) looks muted but volume growth at ~17% YoY (partly due the end-FY09 BPO acquisition) was only slightly lower than FY09's ~19%. High offshore shift (from ~44% to ~51% YoY) reduced reported growth but drove strong margin expansion of ~300bps.
- **BFSI drove growth; Emerging markets revenues over $1bn** — TCS grew ahead of peers as BFSI (~45% of revs) rebounded in FY10. In terms of geographies, the industry benefited from the sharp US recovery – the growth driver for FY10. Emerging markets like LatAm, China, ME and Africa generate over $1bn now.
- **Infosys/TCS – stellar performance in a tough year** — Both Infosys and TCS came out of the downturn strongly with (a) Margin expansion despite pricing pressure on better operational efficiencies, (b) Improved balance sheet – lower debtor days, (c) Investment in sales engine and non-linear models, driving longer-term growth.
- **Non-linearity a key focus** — TCS is working on several fronts to achieve growth via non-linear models. The products business is mature while the other initiatives are at an investment stage and are based on cloud computing. Recently in the media, the TCS CEO suggested that, sometime towards the end of the next financial year, it was looking at ~10% of incremental revenues from non-linear business.
- **Largest private sector employer** — With more than 160,000 employees, TCS is the largest private sector employer in India. In FY10, there was a gross addition of more than 38,000 employees while the attrition at ~12% is amongst the lowest in the industry. TCS continues to invest in the skill development of employees with ~1.5m learning days spent in competency development in key technology areas.
- **Await better entry point** — TCS continues to execute well and delivered a strong FY10. Valuations are at ~20x FY11E EPS and supply side challenges/recent macro concerns should limit multiple expansion – we await better entry point. However, we believe good cash generation and INR depreciation make it a good defensive.

Hold/Low Risk	**2L**
Price (16 Jun 10)	Rs771.90
Target price	Rs855.00
Expected share price return	10.8%
Expected dividend yield	1.4%
Expected total return	**12.2%**
Market Cap	Rs1,510,779M
	US$32,563M

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

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2009A	51,721	26.42	3.0	29.2	9.7	37.0	0.9
2010A	68,729	35.11	32.9	22.0	7.2	37.6	2.6
2011E	75,873	38.76	10.4	19.9	5.8	32.2	1.4
2012E	83,494	42.65	10.0	18.1	4.7	28.5	1.4
2013E	93,790	47.91	12.3	16.1	3.8	26.1	1.4

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Fiscal year end 31-Mar	2009	2010	2011E	2012E	2013E
Valuation Ratios					
P/E adjusted (x)	29.2	22.0	19.9	18.1	16.1
EV/EBITDA adjusted (x)	20.7	17.1	14.9	12.5	10.8
P/BV (x)	9.7	7.2	5.8	4.7	3.8
Dividend yield (%)	0.9	2.6	1.4	1.4	1.4
Per Share Data (Rs)					
EPS adjusted	26.42	35.11	38.76	42.65	47.91
EPS reported	26.42	35.11	38.76	42.65	47.91
BVPS	79.97	107.03	133.78	165.43	202.34
DPS	7.00	20.00	11.00	11.00	11.00
Profit & Loss (RsM)					
Net sales	278,129	300,289	339,987	396,181	451,037
Operating expenses	-212,114	-220,698	-252,083	-295,450	-338,734
EBIT	**66,015**	**79,591**	**87,904**	**100,731**	**112,303**
Net interest expense	-4,673	2,255	3,845	8,673	12,298
Non-operating/exceptionals	-6	-10	0	0	0
Pre-tax profit	**61,336**	**81,836**	**91,749**	**109,404**	**124,601**
Tax	-9,011	-12,089	-15,076	-25,110	-30,011
Extraord./Min.Int./Pref.div.	-604	-1,018	-800	-800	-800
Reported net income	**51,721**	**68,729**	**75,873**	**83,494**	**93,790**
Adjusted earnings	51,721	68,729	75,873	83,494	93,790
Adjusted EBITDA	71,781	86,800	96,904	110,918	123,579
Growth Rates (%)					
Sales	21.7	8.0	13.2	16.5	13.8
EBIT adjusted	23.0	20.6	10.4	14.6	11.5
EBITDA adjusted	20.9	20.9	11.6	14.5	11.4
EPS adjusted	3.0	32.9	10.4	10.0	12.3
Cash Flow (RsM)					
Operating cash flow	**71,458**	**30,303**	**101,333**	**75,975**	**83,968**
Depreciation/amortization	5,766	7,209	9,000	10,188	11,276
Net working capital	8,694	-44,398	19,505	-9,834	-9,600
Investing cash flow	**-12,673**	**-53,876**	**-33,347**	**-16,654**	**-10,037**
Capital expenditure	-7,495	-11,421	-20,519	-17,000	-17,317
Acquisitions/disposals	11,907	-16,382	3,845	8,673	12,298
Financing cash flow	**-18,995**	**-14,183**	**-23,512**	**-21,533**	**-21,533**
Borrowings	-1,788	621	0	0	0
Dividends paid	-13,703	-39,151	-21,533	-21,533	-21,533
Change in cash	**39,791**	**-37,756**	**44,474**	**37,787**	**52,399**
Balance Sheet (RsM)					
Total assets	**226,858**	**274,546**	**340,637**	**413,275**	**495,955**
Cash & cash equivalent	13,440	10,249	70,596	115,911	172,528
Accounts receivable	60,463	58,098	78,197	91,122	103,739
Net fixed assets	37,494	41,706	53,225	60,038	66,078
Total liabilities	**67,215**	**60,978**	**74,707**	**85,384**	**95,807**
Accounts payable	0	0	0	0	0
Total Debt	7,913	3,417	3,383	3,383	3,383
Shareholders' funds	**159,643**	**213,568**	**265,929**	**327,891**	**400,148**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	25.8	28.9	28.5	28.0	27.4
ROE adjusted	37.0	37.6	32.2	28.5	26.1
ROIC adjusted	49.1	42.8	42.4	43.0	42.8
Net debt to equity	-3.5	-3.2	-25.3	-34.3	-42.3
Total debt to capital	4.7	1.6	1.3	1.0	0.8

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BFSI drove growth in FY10

FY10 was a muted year in terms of growth rates for the entire IT industry, given the global macro slowdown. However, TCS's volume growth of ~17% was far ahead of peers (partly helped by an acquisition last year) and reported revenues were lower due to a large offshore shift (which was a big positive contributor to margins). For TCS, revenues grew ~5% in USD terms (volume growth was ~17% while pricing declined ~3%).

BFSI, Retail & Distribution (low base though) key drivers of growth; Manufacturing, Telecom lagged

Retail & Distribution led the growth rates with a volume growth of ~28% YoY (though on a smaller base, ~10% of revenues) while BFSI, comprising ~45% of overall revenues (more than 45,000 associates), bounced back nicely.

Manufacturing and Telecom dragged down the overall growth rates. The discretionary IT spend of the automotive industry shrank in FY10, while the Industrial Manufacturing and Components (IMC) sector, impacted by declining order book positions, cut back even on the "run-the-business" expenses. Telecom witnessed a pull-back in terms of volumes – some of the major customers cut down their spending on outsourcing.

Figure 1. TCS' revenue growth – Vertical-wise

	FY07	FY08	FY09	FY10
BFSI	59.4%	23.1%	18.2%	13.1%
Manufacturing	12.2%	-5.5%	21.2%	-10.6%
Retail & Distribution	66.3%	33.9%	68.0%	28.3%
Telecom	53.3%	22.8%	21.8%	-2.9%
Others	18.4%	27.9%	21.0%	6.0%
Total	40.9%	21.1%	23.0%	8.0%

Source: Company Reports

How does this compare with peer Infosys?

A comparison with Infosys' (INFY.BO; Rs2,741.40; 2L) growth rates in the different industry segment reveals that TCS came in higher in BFSI, Retail & Distribution and Telecom while Infosys fared better in Manufacturing and the "Others" segment. In BFSI, TCS would have benefited from the BPO acquisition, which came in towards the end of FY09 while in Telecom, both companies were impacted by declining growth in one large European customer, in our view.

Figure 2. Comparison of revenue growth – Vertical-wise

	BFSI	Manufacturing	Retail & Distribution	Telecom	Others	Total
TCS	13.1%	-10.6%	28.3%	-2.9%	6.0%	8.0%
Infosys	5.0%	5.4%	11.1%	-6.3%	11.6%	4.8%

Source: Company Reports

~300bps expansion in operating margins

Operating efficiencies, offshore shift and cost management resulted in ~300bps margin expansion in a difficult year

In a tough year with little visibility on growth, the company focused aggressively on operational efficiencies and improved the operating margin by ~300bps YoY. One of the big reasons for the sharp expansion in margins was a big shift in offshore proportion of revenues from ~44% to ~51% of overall revenues.

In terms of verticals, Retail & Distribution led with a margin improvement of ~500bps with BFSI also chipping in with an improvement of ~290bps. Despite a decline in revenues, Manufacturing showed a margin improvement of ~130bps and Telecom had a margin improvement of ~75bps.

How does it stack-up vis-à-vis Infosys?

Infosys also improved its margin YoY by ~140bps, mainly led by BFSI and Telecom, where the margin improvements were either in line with TCS or better. However, Infosys witnessed some decline in margins in the Manufacturing vertical.

Figure 3. Comparison of operating margin change – Vertical-wise

	BFSI	Manufacturing	Retail & Distribution	Telecom	Others	Total
TCS	288bp	133bp	503bp	76bp	224bp	305bp
Infosys	304bp	-38bp	127bp	250bp	47bp	140bp

Source: Company Reports

Americas strong/Europe sluggish in FY10

Americas was the key driver of growth though India/Others did well on a low base

Americas recovered in FY10 and posted a revenue growth of ~11% (comprising ~58% of revenues). Europe, with ~27% of revenues, struggled through the year and declined in revenues. India and the "Others" segment grew nicely, though on much smaller bases (high single digits).

Figure 4. TCS' revenue growth – Geography

	FY07	FY08	FY09	FY10
Americas	34.3%	17.9%	25.9%	10.7%
Europe	78.8%	24.1%	24.4%	-2.5%
India	1.5%	21.6%	6.7%	19.1%
Others	45.9%	35.0%	15.3%	18.2%
Total	40.9%	21.1%	23.0%	8.0%

Source: Company Reports

How does it stack-up vis-à-vis Infosys?

A comparison with Infosys' growth rates in the different geographies reveals that TCS was ahead in most of them, though growth in Americas was largely similar. *This is not a like-to-like comparison, given that TCS would have benefited from the BPO acquisition made in late FY09.*

Figure 5. Comparison of revenue growth – Geography

	Americas	Europe	India	Others	Total
TCS	10.7%	-2.5%	19.1%	18.2%	8.0%
Infosys	9.1%	-8.3%	-7.9%	15.1%	4.8%

Source: Company Reports

Global Network Delivery Model (GNDM)

The Company has been using a network of Global Delivery Centers (GDCs) to service client requirements as part of its GNDM strategy. The composition of Company's revenues from offshore, GDC and onsite were ~51/6/43% respectively in FY10, a meaningful change over FY09 of ~44/5/51%.

As of 31 Mar 10, TCS had 142 offices in 42 countries, as well as 105 delivery centers in 20 countries. It had:

Contribution from GDC continues to inch up – from ~5% in FY09 to ~6% in FY10

- 18 offices in US and Canada
- 12 offices in 7 countries in Latin America
- 11 offices in UK and Ireland
- 22 offices in 12 countries in Europe
- 18 offices in 12 countries in Asia Pacific
- 7 offices in Middle East and Africa
- 54 offices in 13 locations in India

TCS' geographical growth strategy has a two-pronged approach focused on major markets and new growth markets. It continues to pursue localization strategies.

In mature markets like North America, TCS has strengthened local presence by focusing on growing its investments in Cincinnati, Ohio by recruiting local talent to support North American operations. In Europe, the Company has increased its focus on the Western European markets like Germany, France, Benelux and the Nordic region. TCS continues to invest in emerging markets such as Latin America, Middle East, Africa and Eastern Europe.

Non-linear initiatives and Cloud computing

TCS is working on several models to achieve growth through non-linear models. The most mature is the products business with ~3% of revenues (up ~23% YoY) in FY10. While the majority of products are in the BFSI space, TCS is also developing solutions in Healthcare, Retail and the Government sectors.

TCS is looking at ~10% of incremental revenues to come from non-linear business in the next financial year

The other non-linear initiatives are at an investment stage. They are new business models based on cloud computing initiatives. Among the segments that TCS is targeting include small and medium enterprises (charges monthly usage fees on a subscription basis), rural and cooperative banks ("Bank in a Box"). It is also building Process Clouds on a number of horizontal and vertical processes. These investments are expected to mature and progress beyond pilots in FY11.

In a recent media interview, the TCS CEO suggested that, sometime towards the end of the next financial year, it was looking at ~10% of its incremental revenues to come from non-linear business. With an expected industry growth rate of ~15% and revenue base of ~$6.3bn in FY10, the numbers start looking meaningful at ~$100m.

Human Resources

TCS is the largest private sector employer in India with total employee strength of 160,429 (including subsidiaries). The employees are from 80 nationalities – this diverse and global base of employees is central to TCS' competitive strength.

Largest private sector employer in India

- TCS has 10,475 non-Indian nationals amongst its employee base globally.
- The percentage of women working for the company is 30.4%.

Competency and career development continued to be thrust areas for the Company. Overall, 1,458,079 learning days were invested towards competency development in key technology areas and 11,276 managers at various levels attended leadership development programs. To widen the reach of Learning and Development (L&D) globally, 25% of the total L&D effort was delivered through e-Learning in FY10.

More than 17,524 trainees completed the Initial Learning Program (ILP). TCS employees gained 9,151 new technology and process certifications during FY10 as part of the Continuous Learning Program (CLP).

Research & Development

Total R&D expenditure in FY10 was Rs844m (FY09: Rs490m) which was ~0.3% of revenues.

87 patents were filed during the year in several countries. Cumulatively, TCS has filed 295 patent applications of which 60 have been granted. During FY10, there were six patent grants.

The R&D efforts of the Company have resulted in the creation of software tools and usage of these licenses internally has yielded savings of ~$25m according to the company.

Other Data Points

TCS e-Serve witnessed a sharp margin expansion YoY driven by write backs – as per management margins here are in line with rest of the company

- TCS e-Serve Ltd (from the acquisition of Citi BPO), posted a good performance in FY10. It recorded revenues of Rs15.2bn (up ~19% YoY) and profits of Rs6.6bn, which was significantly higher than previous year's Rs0.8bn. *FY10 profits had a one-time write back of ~Rs3.1bn, according to our calculations (company indicated that net margins for TCS e-Serve were in line with the overall company). This would have added ~1% to the company overall net margins.*
- The TCS Group has provided guarantees aggregating to Rs17.2bn (£252.5m) (unchanged YoY) to third parties on behalf of its subsidiary Diligenta Ltd. The Group does not expect any outflow of resources in respect of the above.
- TCS Financial Solutions increased its customers by adding 53 new clients during FY10. In addition, 36 clients went "live" on BaNCS solutions during the year.
- DSOs were 71 days as on 31 Mar 10 (79 days as on 31 Mar 09). The Company took steps to improve the billing and collection process and put in place a continuous monitoring system.
- The closing balance of hedging reserve account as at 31 Mar 10 showed a loss of Rs61m (Rs7.3bn loss as at 31 Mar 09).

Tata Consultancy Services

Company description

TCS is the largest and among the oldest IT companies in India. It is a part of the diversified Tata Group, one of the largest corporate groups in Asia, with more than 160,000 employees, including subsidiaries. It provides a comprehensive range of IT services to industries such as Banking & Financial Services, Insurance, Manufacturing, Telecom, Retail and Transportation. It has more than 900 active clients. The company started with data processing work in 1968, and was the first to provide offshore services in 1974. Over the past three decades, it 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 Hold/Low Risk (2L). The stock has outperformed the Indian markets by more than 100% since the beginning of 2009. The company has benefitted significantly from the return of spends in the BFSI segment and we are worried that this might taper. We may see good growth in FY11 due to pent up demand, however, we are concerned that expectations are running ahead of reality. Its earlier valuation discount vis-à-vis Infosys has virtually ceased to exist.

Valuation

Our target price of Rs855 is based on 21x the average of FY11-12E EPS. Given that businesses are bottoming and we estimate TCS' earnings will grow at an ~11% CAGR over FY10-13E, we believe the stock should trade closer to the higher end of its historical three-year trading range of 7-27x 12-month forward earnings. We believe PE remains the most appropriate valuation measure given TCS' past profitability and future earnings visibility.

Risks

We rate TCS Low Risk despite our quantitative risk-rating system suggesting High Risk. The company has significant scale, enjoys a good brand name and continues to generate significant FCF. Key downside risks that could cause the shares to be lower than our target price are: 1) any significant appreciation of the rupee against the USD/EUR/GBP; 2) a prolonged recession in the US; and (3) any margin-dilutive acquisition. Key upside risks that could cause the shares to be higher than our target price are: 1) any significant depreciation of the rupee against the USD/EUR/GBP; 2) aggressive pent up demand from corporates in the US; and 3) any margin accretive acquisition.

Infosys Technologies

(INFY.BO; Rs2,741.40; 2L)

Valuation

Our Rs2,935 target price for Infosys is based on 22x the average of FY11-12E EPS. This is around the mid-point of the last 3-year trading band of 11x-30x 12-month forward earnings and factors in some deceleration in growth. Our estimates continue to assume a certain P/E premium to the market; this is justified, in our view, given the strong FCF and ROIC for Infosys vs. the overall market. We believe P/E remains the most appropriate valuation measure given Infosys' profitability record and higher earnings visibility.

Risks

We rate Infosys Low Risk given its superior branding, management quality and cost optimization abilities. This is in line with our quantitative risk-rating system, which tracks 260-day historical share price volatility. Key downside risks to our target price include: 1) any significant appreciation of the rupee against the USD/EUR/GBP; 2) pressure on billing rates (as Infosys still continues to enjoy a 10-15% premium in its billing rates); 3) a prolonged slowdown in the US economy; and 4) limited H1B visas. Key upside risks include: 1) any significant depreciation of the rupee against the USD/EUR/GBP; and 2) a pickup in the US/global economy.

Appendix A-1

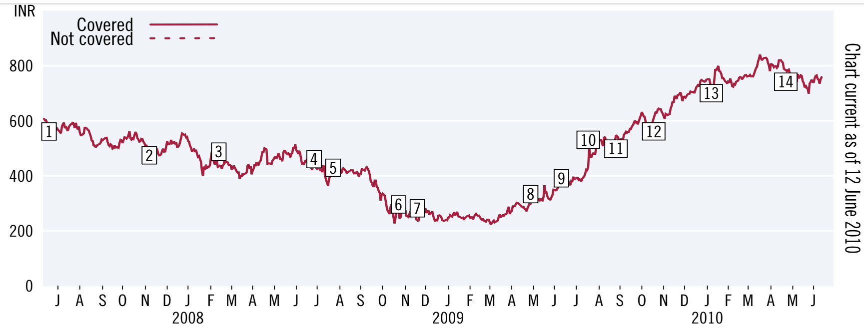
Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of all or any identified portion of this research report hereby certifies that, with respect to each issuer or security or any identified portion of the report with respect to an issuer or security that the research analyst covers in this research report, all of the views expressed in this research report accurately reflect their personal views about those issuer(s) or securities. The research analyst(s) also certify that no part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this research report.

IMPORTANT DISCLOSURES

Tata Consultancy Services (TCS.BO)

Ratings and Target Price History
Fundamental Research
Analyst: Surendra Goyal, CFA



	Date	Rating	Target Price	Closing Price
1	13-Jun-07	1L	*730.00	601.40
2	7-Nov-07	1L	*645.00	499.13
3	13-Feb-08	*1M	*582.50	434.48
4	26-Jun-08	1M	*587.50	438.43
5	23-Jul-08	*2M	*462.50	429.25
6	23-Oct-08	2M	*312.50	273.73
7	19-Nov-08	*2H	*280.00	240.43
8	28-Apr-09	*3M	*307.50	299.30
9	10-Jun-09	*1L	*465.00	390.88
10	17-Jul-09	1L	*525.00	433.60
11	26-Aug-09	1L	*630.00	548.30
12	19-Oct-09	1L	*695.00	599.00
13	7-Jan-10	1L	*855.00	714.65
14	22-Apr-10	*2L	855.00	785.30

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Infosys Technologies (INFY.BO)

Ratings and Target Price History
Fundamental Research
Analyst: Surendra Goyal, CFA

	Date	Rating	Target Price	Closing Price
1	7-Nov-07	1L	*2,190.00	1,743.85
2	13-Feb-08	*1M	*2,060.00	1,549.15
3	26-Jun-08	1M	*2,175.00	1,781.85
4	23-Jul-08	1M	*1,910.00	1,603.70
5	19-Nov-08	1M	*1,420.00	1,172.00
6	4-Jan-09	1M	*1,350.00	1,130.95
7	28-Apr-09	*1L	*1,650.00	1,431.55
8	10-Jun-09	1L	*2,060.00	1,803.25
9	26-Aug-09	*2L	*2,290.00	2,181.35
10	7-Jan-10	2L	*2,785.00	2,525.25
11	23-Apr-10	2L	*2,935.00	2,728.10

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Rohini Malkani has in the past worked with the India government or its divisions in her personal capacity.

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Citi Investment Research & Analysis Ratings Distribution

Data current as of 31 Mar 2010	**Buy**	**Hold**	**Sell**
Citi Investment Research & Analysis Global Fundamental Coverage	51%	36%	14%
% of companies in each rating category that are investment banking clients	48%	46%	39%

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