

Strong volume growth; dismisses all concerns

- In 1QFY12, TCS delivered 7.5% QoQ (US\$) revenue growth (above our expectation). Revenue growth was driven by strong volume growth of 7.4% QoQ. Growth was broad-based, with Europe and the US growing ~6.5% QoQ. Strong growth in discretionary services such as ERP (8.1% QoQ) indicates the strength in the demand momentum.
- EBITDA margins fell 230bps QoQ and 130bps YoY on salary increases and an appreciating currency. With a high employee utilisation (76%) and offshore mix, we believe that TCS has few levers left; we see a modest improvement in margins in 2QFY12.
- TCS has delivered a positive surprise on heightened expectations. We increase our FY12ii EPS estimate by ~4%, due to better revenue growth and higher-than-expected other income.
- After the recent correction, TCS' valuation is now at par with that of Infosys (FY12ii P/E). We estimate TCS to record a ~4pps better PAT CAGR than Infosys over FY11-14 and we expect a re-rating ahead.

Result update

		Price performance (%)		
	Rs1,124	1M	3M	1Y
CMP				
12-mth TP (Rs)	1,305 (16%)			
Market cap (US\$ m)	49,384			
Bloomberg	TCS IN			
Sector	IT Services			
Shareholding pattern (%)		Stock performance		
Promoters	74.1	52Wk High/Low (Rs)		1,247/763
FII's	12.6	Shares o/s (m)		1957
DII's	8.1	Daily volume (US\$ m)		43
Public	5.2	Dividend yield FY12ii (%)		1.5
		Free float (%)		26.0

Financial summary (Rs m)

Y/e 31 Mar	2QFY10	3QFY10	4QFY10	1QFY11	2QFY11	3QFY11	4QFY11	1QFY12	2QFY12ii	FY11	FY12ii	FY13ii
Offshore mix	51.1	51.3	51.0	51.2	51.1	51.4	50.3	50.8	50.8	51.0	51.0	51.0
Change (qoq/yoy, pps)	0.7	0.2	-0.3	0.2	-0.1	0.3	-1.1	0.5	0.0	0.0	0.0	0.0
Employee headcount	141,962	149,654	160,429	163,700	174,417	186,914	198,614	202,190	218,338	198,614	238,337	286,004
% growth (qoq, yoy)	0.2%	5.4%	7.2%	2.0%	6.5%	7.2%	6.3%	1.8%	8.0%	23.8%	20.1%	20.0%
Employee utilization	73.6	77.2	74.3	74.8	77.7	77.1	75.1	76.1	74.6	76.2	77.0	77.0
Change (qoq/yoy, pps)	2.3	3.6	-2.9	0.5	2.9	-0.6	-2.0	1.0	-1.5	2.1	0.8	0.0
Revenues (Rs m)	74,351	76,503	77,365	82,173	92,864	96,634	101,575	107,970	117,560	373,246	477,290	575,530
% change	6.9	5.1	7.9	14.0	24.9	26.3	31.3	31.4	26.6	24.3	27.9	20.6
EBITDA (Rs m)	21,342	22,717	23,121	24,155	27,773	29,178	30,882	30,310	34,542	111,988	140,230	167,679
EBITDA Margins (%)	28.7	29.7	29.9	29.4	29.9	30.2	30.4	28.1	29.4	30.0	29.4	29.1
Interest expense (Rs m)	-84	-84	-284	-139	-20	0	0	0	0	-200	-314	-314
Effective tax rate (%)	15.0	15.1	14.3	19.1	18.7	18.8	21.8	22.7	23.5	20.0	23.3	21.0
Reported PAT (Rs m)	16,239	17,975	19,312	18,633	21,388	23,464	23,811	23,804	26,064	85,984	106,755	131,051
PAT (Pre-Exceptional) (Rs m)	16,239	17,975	19,312	18,633	21,388	23,464	23,811	23,804	26,064	85,984	106,755	131,051
% change	28.7	32.9	46.9	22.6	31.7	30.5	23.3	27.8	21.9	25.1	24.2	22.8

Source: Company, IIFL Research. Priced as on 14 July 2011

Figure 1: 1QFY12 - financial summary

Income stmt brief (Rs m)	1QFY11	4QFY11	1QFY12	QoQ	YoY
Net sales	82,173	101,575	107,970	6.3%	31.4%
Net Sales (US\$ m)	1,794	2,244	2,412	7.5%	34.4%
Cost of services	-44,129	-53,784	-58,791		
Gross profits	38,044	47,791	49,179	2.9%	29.3%
Gross margins	46.3%	47.0%	45.5%		
SG&A	-13,889	-16,909	-18,869		
EBITDA	24,155	30,882	30,310	-1.9%	25.5%
EBITDA margin	29.4%	30.4%	28.1%	-233 bps	-132 bps
Depreciation	-1,575	-2,123	-2,049		
Other income	820	2,239	2,887		
PBT	23,400	30,998	31,148	0.5%	33.1%
PBT margin	28.5%	30.5%	28.8%		
Tax	-4,475	-6,772	-7,063		
Effective tax rate	19.1%	21.8%	22.7%		
PAT	18,633	23,811	23,804	0.0%	27.8%
PAT margin	22.7%	23.4%	22.0%		
EPS	9.5	12.2	12.2	0.0%	27.8%
Operating metrics					
Volume QoQ	8.1%	2.9%	7.5%		
Onsite revenue mix	43.6%	44.7%	44.8%	10 bps	120 bps
Utilization with trainees	74.8%	75.1%	76.2%	110 bps	140 bps
Total employees	163,700	198,614	202,190	1.8%	23.5%
Gross addition	10,849	19,324	11,988		
Top client contribution	8.1%	7.4%	7.1%	-30 bps	-100 bps
Top 10 contribution	30.5%	29.6%	28.9%	-70 bps	-160 bps
Fixed price	49.1%	49.5%	49.7%	20 bps	60 bps

Source: Company, IIFL Research

Revenue growth of 7.5% was above our expectation.

Break-down of revenue growth:

- Volume growth: 7.4%
- Realisations: -0.5%
- Offshore mix: -0.75%
- Cross-currency: ~1.2%

EBITDA margin break-down:

Wage increases: -251bps

Utilisation: +115bps

SG&A: -80BPS

Higher interest yields and forex gains (registered a forex loss in 4QFY11) led to strong growth in other income

Effective tax rates were lower than the company's earlier indication of 23.5%

Employee utilisation (ex-trainees) is near the peak of the company's target range of 84%

TCS' gross hiring target is ~20,000 for 2QFY12 and 60,000 for FY12

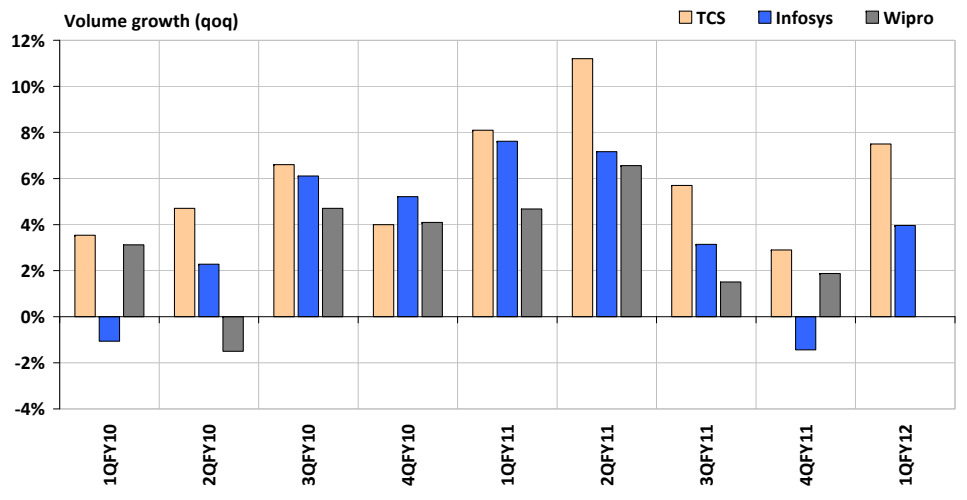
Emerging markets/non-top-10 clients led the growth

Strong discretionary spend underscores the robust demand momentum

TCS’ strong volume growth of 7.4% indicates a strong environment for execution and dismisses any concerns over delay in decision-making. Further, robust growth in discretionary services such as package implementation (8.1% QoQ) highlights the strength in the demand environment.

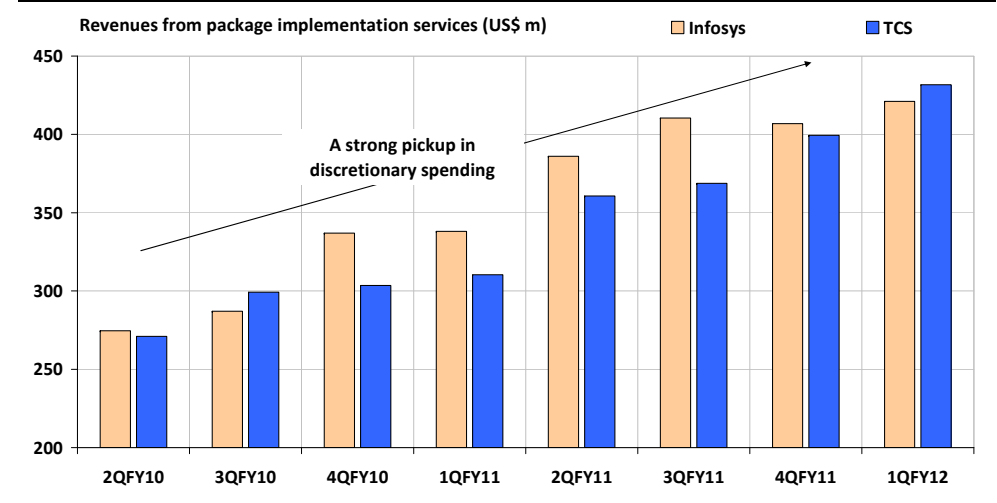
Moreover, the management indicated that the discretionary environment is improving further. Discretionary projects formed a higher proportion of recent deal wins, compared with even six months ago. The pipeline of ~15 large deals suggests that discretionary spending is accelerating.

Figure 2: TCS’ volume growth has been markedly higher than that of peers over the recent past



Source: Company, IIFL Research

Figure 3: A strong environment for discretionary spends



Source: Company, IIFL Research

Emerging markets grow 12% QoQ

Growth was broad-based across key geographies, with the US and Europe growing at ~6.5% QoQ. Emerging markets recorded an exceptionally strong quarter, with revenue from India and other APAC countries growing ~11% QoQ. Strong growth in the emerging markets was partly driven by surge in discretionary/telecom projects; considering the traction in discretionary spending and the company’s strong deal wins in recent times, we expect growth from emerging markets to continue to be healthy.

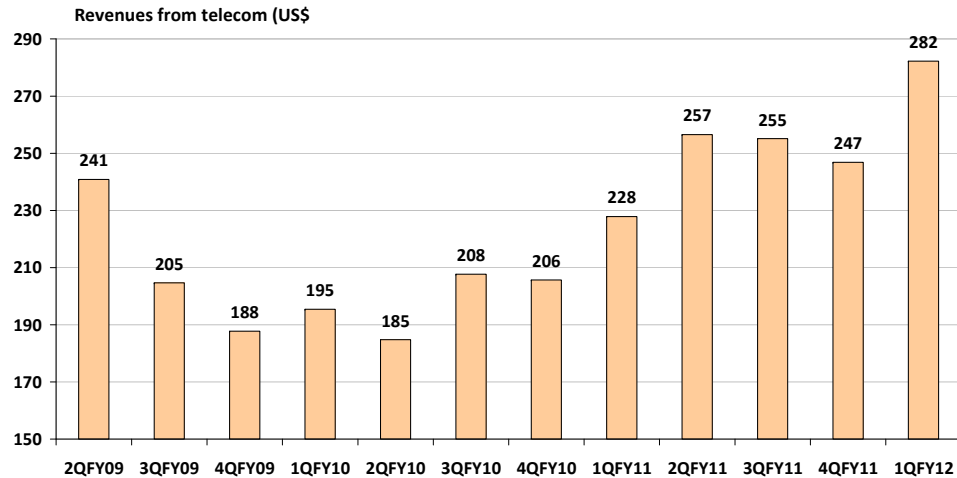
Despite the ‘macro’ overhang, Europe grew a strong 6.5% QoQ (estimated to be 3.6% after adjusting for exchange rate movements). TCS was able to achieve robust growth in this geography on the back of strong performance across its retail and financial services verticals. Traction in discretionary services and increasing deal wins should underpin growth from Europe.

Broad-based growth across verticals

While all the key verticals recorded robust growth in 1QFY12, retail and high-tech were the strongest. The management’s commentary indicates

that traction in BFSI and retail was among the best. Surge in discretionary spending boosted revenue from the telecom vertical, but the demand environment in the sector continues to be weak.

Figure 4: Even the 'weak' telecom vertical has been growing steadily for TCS



Source: Company, IIFL Research

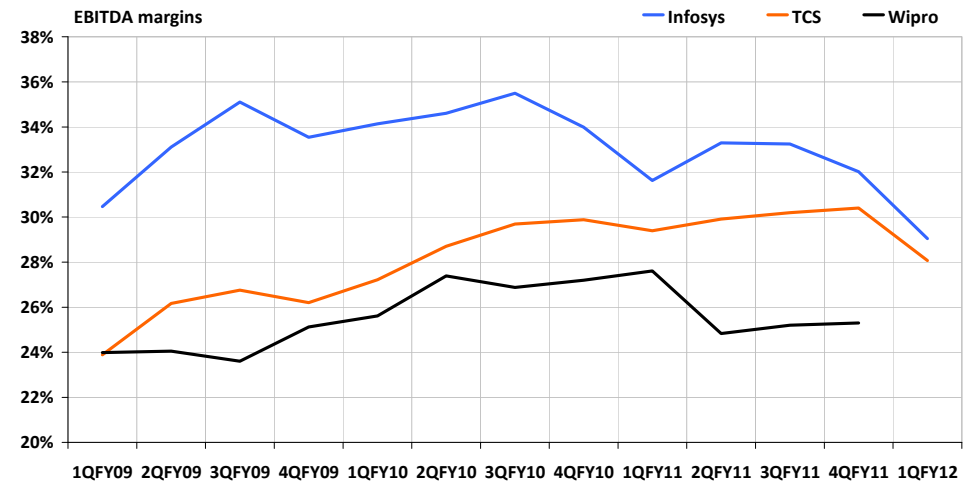
Pricing is favourable

Realisations were stable during 1QFY12 (-0.5% QoQ). The marginal fall in realisations was most likely due to a higher share of revenue from emerging markets. Moreover, the management indicated that pricing is better on new deals and in contract renewals. With discretionary spending picking up further, we expect pricing to remain favourable for the large IT vendors.

Limited margin levers

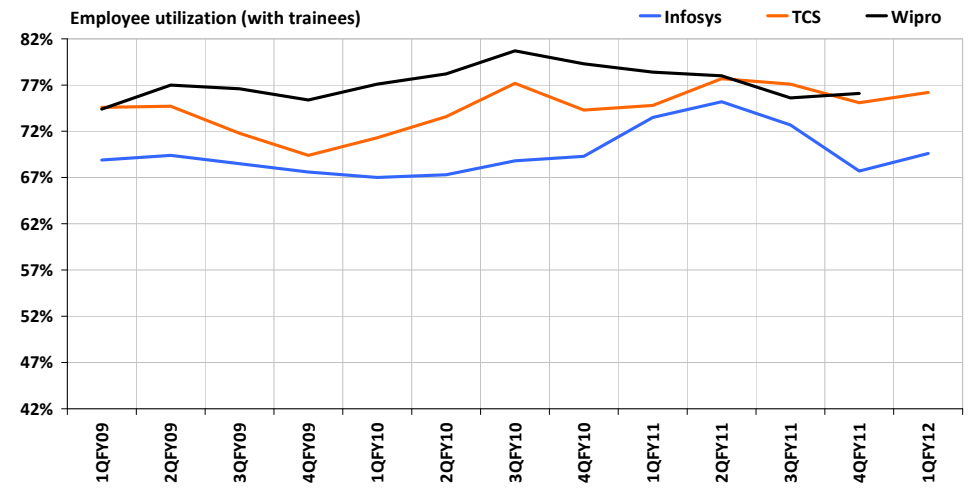
We believe that some of the margin levers that TCS utilised in the recent past have reached optimal levels. For instance, we do not expect utilisations (76.2% in 1QFY12) or offshore mix (50.6%) to be margin levers, going forward.

Figure 5: TCS' EBITDA margin is only 100bps lower than that of Infosys



Source: Company, IIFL Research

Figure 6: TCS' employee utilisation was high



Source: Company, IIFL Research

The management expects margins to improve in 2QFY12 despite the intake of freshers. We see only a moderate improvement. Attrition increased to ~17% during 1QFY12 and the high employee utilisation (83.2% w/o trainees) leaves little slack. Thus, despite the SG&A levers, we expect the margin improvement in 2QFY12 to be limited, and margins should remain flat over FY11-14ii.

Figure 7: Performance by industry segments

Revenue by verticals	1QFY12 – rev. contr	QoQ (US\$)
BFSI	43.2%	5.5%
Telecom	11.7%	14.3%
Manufacturing	7.6%	8.9%
Retail and Distribution	11.6%	11.3%
Hi Tech	5.8%	15.4%
Life Sciences and Healthcare	5.2%	5.5%
Travel and hospitality	3.7%	2.0%
Energy and Utilities	3.8%	-11.2%
Media and entertainment	2.2%	2.8%
Others	5.1%	14.2%

Source: Company, IIFL Research

Figure 8: Performance by geographies

Revenue by geographies	1QFY12 – rev. contr	QoQ (US\$)
North America	52.9%	6.5%
UK	15.3%	6.1%
Continental Europe	9.9%	7.5%
India	9.3%	13.6%
Apac	7.3%	9.0%

Source: Company, IIFL Research

Figure 9: Performance by service lines

Revenue by service lines	1QFY12 – rev. contr	QoQ (US\$)
ADM	46.2%	7.7%
Business Intelligence	4.9%	7.5%
Engineering	4.6%	3.0%
Infrastructure Services	9.5%	12.2%
Enterprise Solutions	10.8%	7.5%
Consulting	2.2%	12.6%
Asset Leverage Solutions	3.6%	7.5%
Assurance	7.3%	12.1%
BPO	10.9%	1.0%

Source: Company, IIFL Research

Valuation summary (Rs m)

Y/e 31 Mar	FY10A	FY11A	FY12ii	FY13ii	FY14ii
Revenues (Rs m)	300,289	373,246	477,290	575,530	679,720
EBITDA Margins (%)	28.9	30.0	29.4	29.1	29.5
Pre-Exceptional PAT (Rs m)	68,739	85,984	106,755	131,051	159,299
Reported PAT (Rs m)	68,739	85,984	106,755	131,051	159,299
EPS (Rs)	35.1	43.9	54.5	67.0	81.4
Growth (%)	28.4	25.1	24.2	22.8	21.6
IIFL vs consensus (%)			3.8	7.4	11.5
PER (x)	32.0	25.6	20.6	16.8	13.8
ROE (%)	36.9	36.6	36.6	35.5	34.4
EV/EBITDA (x)	24.4	18.9	14.8	12.0	9.7
Price/Book (x)	10.5	8.7	6.8	5.4	4.3

Source: Company data, IIFL Research

Assumptions

Y/e 31 Mar	FY10A	FY11A	FY12ii	FY13ii	FY14ii
Revenue growth (US\$, YoY)	4.7%	29.4%	29.8%	20.4%	18.1%
Exchange rate (US\$/INR)	47.5	45.6	44.9	45.0	45.0
Effective tax rate	14.8%	19.7%	23.3%	21.0%	20.0%

Source: Company data, IIFL Research

Financial summary

Income statement summary (Rs m)

Y/e 31 Mar	FY10A	FY11A	FY12ii	FY13ii	FY14ii
Revenue	300,289	373,246	477,290	575,530	679,720
EBITDA	86,799	111,988	140,230	167,679	200,512
EBIT	79,591	104,774	131,910	159,021	191,503
Interest income	2,097	3,877	8,357	9,138	10,285
Profit before tax	81,846	108,914	140,861	167,846	201,474
Tax expense	-12,089	-21,739	-32,846	-35,248	-40,295
Net Profit	68,739	85,984	106,755	131,051	159,299

Cash flow summary (Rs m)

Y/e 31 Mar	FY10A	FY11A	FY12ii	FY13ii	FY14ii
EBIT	79,591	104,774	131,910	159,021	191,503
Depreciation & Amortization	7,208	7,214	8,320	8,658	9,009
Tax paid	-12,089	-21,739	-32,846	-35,248	-40,295
Working capital change	16,203	-25,850	-17,620	-16,637	-17,645
Other operating items	-2,883	4,034	-1,260	-1,547	-1,880
Operating Cash-flow	88,030	68,433	88,504	114,247	140,692
Capital expenditure	-11,424	-17,848	-23,000	-17,500	-17,500
Free cash flow	76,606	50,585	65,504	96,747	123,192
Dividends paid	-24,145	-32,087	-37,503	-46,039	-55,962
Net change in Cash & cash equivalents	61,966	12,550	36,951	59,533	77,201

Source: Company data, IIFL Research

Balance sheet summary (Rs m)

Y/e 31 Mar	FY10A	FY11A	FY12ii	FY13ii	FY14ii
Cash & cash equivalents	85,058	92,697	129,649	189,182	266,383
Sundry debtors	91,376	124,547	159,265	192,046	226,813
Fixed assets	41,706	52,340	67,021	75,863	84,354
Intangible assets	32,415	32,455	32,455	32,455	32,455
Other assets	25,657	30,569	30,569	30,569	30,569
Total assets	276,213	332,608	418,957	520,114	640,572
Other current liabilities	56,516	63,837	80,935	97,079	114,201
Long-term debt/Convertibles	1,111	1,040	1,040	1,040	1,040
Other long-term liabilities	5,413	10,678	10,678	10,678	10,678
Minorities/other Equity	3,768	4,663	4,663	4,663	4,663
Networth	209,404	252,389	321,641	406,654	509,990
Total liabilities & equity	276,213	332,608	418,957	520,114	640,572

Ratio analysis

Y/e 31 Mar	FY10A	FY11A	FY12ii	FY13ii	FY14ii
Sales growth (%)	8.0	24.3	27.9	20.6	18.1
Core EBITDA growth (%)	20.9	29.0	25.2	19.6	19.6
Core EBIT growth (%)	20.6	31.6	25.9	20.6	20.4
Core EBITDA margin (%)	28.9	30.0	29.4	29.1	29.5
Core EBIT margin (%)	26.5	28.1	27.6	27.6	28.2
Net profit margin (%)	22.9	23.0	22.4	22.8	23.4
Dividend payout ratio (%)	35.1	37.3	35.1	35.1	35.1
Tax rate (%)	14.8	20.0	23.3	21.0	20.0
Net Debt/Equity (%)	41.1	37.1	40.6	46.8	52.4
Return on Equity (%)	36.9	36.6	36.6	35.5	34.4
Return on Assets (%)	27.2	28.2	28.4	27.9	27.4

Source: Company data, IIFL Research

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.

SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.

Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.

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