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Service Truly Personalized

TCS

Buy

CMP: Rs 1,250

Target Price: Rs 1,440 (12 Months)

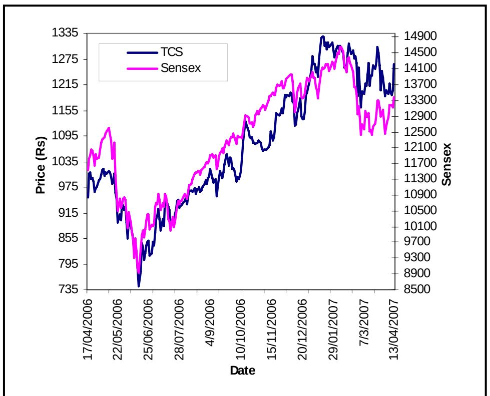
Harit Shah

Tel: 022 – 4040 3800 Ext: 345
e-mail: harit.shah@angeltrade.com

Sector	IT
Market Cap (Rs cr)	1,22,277
Beta	0.9
52 WK High / Low	1,399 / 728
Avg Daily Volume	281697
Face Value (Rs)	1
BSE Sensex	13,607
Nifty	3,985
BSE Code	532540
NSE Code	TCS
Reuters Code	TCS.BO
Bloomberg Code	TCS@IN

Shareholding Pattern (%)	
Promoters	81.6
MF/Banks/Indian FIs	4.9
FII/ NRIs/ OCBs	7.1
Indian Public/ Others	6.4

Share Price Vs Sensex



Q4FY2007 Results Update

Performance Highlights

- **Strong topline growth driven by volumes, despite rupee appreciation**
  TCS grew its revenues at a decent pace of 5.9% QoQ during Q4FY2007. This was mainly a result of good volume growth to the extent of 6.4% QoQ, pricing-led improvements to the tune of 89bps and productivity improvements of 44bps. However, the rupee appreciation during the quarter led to an adverse impact of around 1.9% on the topline growth, thus leading to the growth in rupee terms being slower than the dollar growth, which was impressive at 8% QoQ. TCS continues to grow its global delivery model and revenues from its global delivery centres (GDCs) accounted for 4.6% of total revenues in Q4FY2007. The company now has delivery centres in places like China, Mexico, Brazil and Latin America and in opening a new development centre in Morocco, a clear testimony to the fact that it has by far the widest global network among all the top-tier software companies. This undoubtedly gives TCS an edge over its peers, serving as a competitive differentiator.

- **Productivity improvements aid margins**
  During Q4FY2007, TCS managed to maintain its EBITDA margins at the same level as was the case in the previous quarter, in fact, actually managing a marginal expansion of 1bp. The appreciating rupee had a negative impact of 57bps on the margins, which was effectively set off through improvements in productivity and higher utilisation rates (79.6% excluding trainees in Q4FY07 Vs 78.2% in Q3FY07). Thus, TCS has clearly shown its ability to manage margins even in the face of stiff headwinds such as volatile currency movements.

- **Higher other income enables decent bottomline growth**
  TCS saw a decent 6.2% QoQ growth in its bottomline for the quarter. Other income provided a strong fillip to the bottomline growth, growing at as much as 199.5% QoQ. Thus, this was the major factor that enabled the bottomline to grow at a faster pace than the topline, even as depreciation charges and tax payments rose at QoQ rates of 29.2% and 19.7% respectively.

Exhibit 1: Key Financials

Y/E March (Rs cr)	FY2006	FY2007	FY2008E	FY2009E
Net Sales	**13,245**	**18,633**	**24,820**	**31,735**
% chg	*36.2*	*40.7*	*33.2*	*27.9*
Net Profit	**2,883**	**4,132**	**5,185**	**6,406**
% chg	*40.5*	*43.3*	*25.5*	*23.5*
EBITDA Margin (%)	27.7	27.2	26.7	26.2
EPS (Rs)	**29.5**	**42.2**	**53.0**	**65.5**
P/E (x)	42.4	29.6	23.6	19.1
P/CEPS (x)	38.6	26.8	21.0	16.9
RoE (%)	63.8	55.5	47.2	42.2
RoACE (%)	58.4	53.4	47.5	43.5
P/BV (x)	20.9	13.5	9.5	7.0
EV/Sales (x)	9.2	6.4	4.7	3.6
EV/EBITDA (x)	33.2	23.6	17.7	13.7

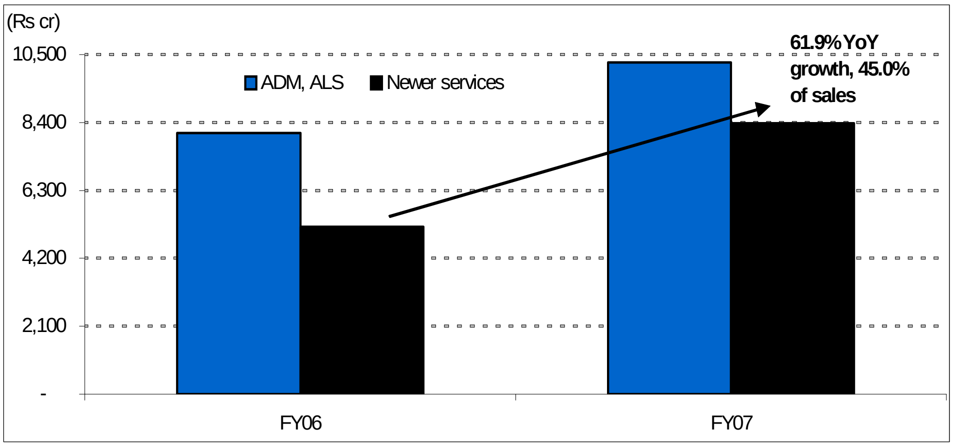
Source: Company, Angel Research

Full-year topline powered by growth across-the-board

During fiscal FY2007, TCS recorded a strong 40.7% YoY growth in its topline, which hit Rs 18,633cr. TCS' 'full-services model' enabled it to win as many as 12 US$ 50mn deals during the year, of which 5 deals were 'full-services deals', involving more than one service of TCS. Deals if this nature, involving IT services, BPO and infrastructure services, provide high revenue visibility and assured volumes to the company with low incremental costs and TCS has undoubtedly been a front-runner in bagging large, integrated, 'full-service' deals that it can execute globally by leveraging its vast global delivery model.

The strong traction being witnessed by the company is reflected in the strong growth across-the-board of its major service lines. The bread-and-butter Application Development and Maintenance (ADM) business witnessed a decent 26.2% YoY growth, enabled by continued ramping up of major deals won in the recent past. The new service lines of the company, excluding ADM and asset-leveraged solutions (products), have shown admirable growth in FY2007, increasing their contribution to total revenues from 39.1% in FY2006 to 45.0% this fiscal. These services have grown at an admirable pace of 61.9% YoY in FY2007, with services such as assurance services (testing) and infrastructure services growing at rates between 90% YoY and 120% YoY. BPO, in fact, grew at an astonishing pace of 482.8% YoY to cross Rs 1,000cr (Rs 1,081cr), aided by acquisitions.

Exhibit 2: New service lines power growth



Source: Company, Angel Research

BFSI, Telecom, Retail drive the verticals

As regards TCS' vertical break-up, it was the key banking, financial services and insurance (BFSI) vertical that was the major driver of growth for the company. This vertical grew by 44.1% YoY, accounting for 44.7% of the incremental revenues for FY2007. The company has said that it is not impacted in any significant manner by the current meltdown in the US sub-prime mortgage market, as a miniscule proportion of its revenues come from that space. The other verticals that proved to be strong growth drivers were telecom (grew by 58.4% YoY) and retail & distribution (53.7% YoY). The telecom vertical is witnessing good traction, with global telecom majors (service providers) investing significantly in upgrading their networks to 'next-generation networks', a term used to describe, in simple terms, networks capable of carrying voice as well as data traffic across the globe. These networks will cater to the ever-increasing demand for high quality data services globally and will enable telcos to introduce newer services at a faster time-to-market. For example, British Telecom (BT) is investing as much as £ 10bn in its transformation initiative, 21st Century Network (21CN). TCS had also earlier won a US$ 250mn deal from Tata Teleservices to manage its entire IT infrastructure. With the Indian telecom market the fastest-growing in the world, adding a massive 6mn-plus customers a month, there is huge potential to be had in this industry going forward.

US, Europe continue to show the way among the geographies

During FY2007, it was the European geography that was the key growth driver, growing at an impressive rate of 82.2% YoY. In Europe, the UK grew at 87.9% YoY, while Continental Europe witnessed a strong 69.6% YoY growth. Thus, the European region increased its share in total revenues to 28.5% in FY2007 (22.0% in FY2006). The key US geography (North America) grew at 31.4% YoY, accounting for 43.2% of the incremental revenues this fiscal. Ibero America (Latin America) grew at a scorching pace of 188.88% YoY, albeit on a lower base. Thus, these are clear signs of impressive geographical diversification by TCS, away from North America. Of course, the US being the largest market for IT services globally, we expect a majority of the company and industry's revenues to continue to come from that region; however, geographic diversification into places like Europe, Japan, Australia and Latin America is imperative if these companies are to reduce their dependence on the US.

Employee costs pressurise margins

TCS witnessed a 48bps fall in its EBITDA margins during FY2007. The primary reason for this was higher employee costs. These increased as a percentage of sales to 54.5% (52.3% in FY2006). This is a continued endorsement of our stand that wage inflation will continue to adversely impact margins of software companies, even as the companies themselves expect to be able to maintain margins at current levels. The attrition rate has also risen to 11.3% in FY2007, from 9.9% in FY2006. The company ended the fiscal with 89,419 employees on its rolls (consolidated). It expects to hike offshore salaries by around 12% to 15% in FY2008, while onsite salaries are expected to rise by 3% to 5%.

Higher other income powers net profits

TCS saw an impressive 43.3% YoY growth in its net profits, which grew at a faster pace than the topline. This was enabled even as margins were under some pressure. Other income saw a massive 921.9% YoY growth in FY2007, thus enabling the impressive bottomline growth.

Client data

TCS added a net of 172 clients during FY2007 and the active client base of the company now stands at 920. The total number of clients giving the company revenues in excess of US$ 1mn hit 297 at the end of FY2007 (256 at the end of FY2006). As a matter of fact, the number of clients in all the revenue buckets has shown a significant improvement over the last fiscal, reflecting the impressive client-mining abilities of the company and the strong long-term relationships that it shares with its major clients.

Outlook and valuations

TCS has hit virtually bull's eye on our topline estimates for FY2007. While we had estimated the company to hit Rs 18,634cr, the company managed to hit Rs 18,633cr. However, on the margins front, TCS saw further fall compared with what we had originally anticipated, witnessing a 48bps fall, as compared to our estimates of a 30bps fall. On the bottomline front, the company has slightly out-performed our estimates, hitting Rs 4,132cr, compared with our estimates of Rs 4,121cr.

Going forward, we expect TCS to record a 30.5% CAGR in topline between FY2007 and FY2009, while we expect the bottomline to clock a 24.5% CAGR in that period. We expect margins to fall by around 50bps each year, mainly due to continued wage inflation. The demand environment appears strong for TCS and the company, with its 'full-services model' and global delivery network, appears well-positioned to reap the benefits of the strong growth expected in the global offshoring industry. Nonetheless, we believe that headwinds such as higher attrition rates, wage inflation and currency appreciation could play spoilsport in future and greater-than-expected appreciation of the rupee against the US dollar would be a downside risk to our estimates.

At the CMP, the stock trades at 19.1x FY2009E EPS. We maintain a BUY on the stock with a 12-month target price of Rs 1,440.

Exhibit 3: Financial performance (US GAAP Consolidated)

Y/E March (Rs cr)	FY2007 Q4	Q3	% chg (QoQ)	FY2006 Q4	% chg (YoY)	FY2007	FY2006	% chg (YoY)
Net revenues	**5,146**	4,860	***5.9***	**3,723**	***38.2***	**18,633**	13,245	***40.7***
Cost of revenue	2,718	2,576	*5.5*	2,045	*32.9*	10,121	7,160	*41.4*
Gross profit	**2,429**	2,285	***6.3***	1,679	*44.7*	**8,512**	6,085	***39.9***
SG&A expenses	972	909	*6.9*	696	*39.7*	3,438	2,415	*42.4*
EBITDA	**1,457**	1,375	***5.9***	983	*48.2*	**5,074**	3,670	***38.2***
Other income	90	30	*199.5*	(4)		194	19	*921.9*
Depreciation	140	108	*29.2*	86	*61.3*	430	281	*52.9*
Income before income taxes	**1,407**	1,297	***8.5***	893	*57.7*	**4,839**	3,408	***42.0***
Equity in net earnings of affiliates	0	2		3		4	2	
Minority interest	16	11		10		42	28	
Tax	219	183	*19.7*	90	*143.8*	670	499	*34.3*
Net income	**1,173**	1,105	***6.2***	**796**	***47.4***	**4,132**	2,883	***43.3***
Diluted EPS (Rs)	**12.0**	11.3		**8.1**		**42.2**	29.5	
Gross profit margin (%)	47.2	47.0		45.1		45.7	45.9	
EBITDA margin (%)	28.3	28.3		26.4		27.2	27.7	
Net profit margin (%)	22.8	22.7		21.4		22.2	21.8	

Source: Company, Angel Research

Angel Broking Limited

Research Team Tel: 4040 3800 E-mail: research@angelbroking.com Website: www.angeltrade.com