Tata Consultancy Services TCS.NS TCS IN .

SOFTWARE & SERVICES

NOMURA
EQUITY RESEARCH

Fails to meet heightened Street expectations

In-line quarter, but miss on Street expectations to weigh on valuation

October 18, 2011

Rating Remains	**Neutral**
Target price Increased from 1070	INR 1100
Closing price October 17, 2011	INR 1120
Potential downside	-1.8%

Action: Miss on consensus numbers; negative reaction likely

TCS's 2Q results miss on consensus USD revenue growth and PAT could likely weigh on stock price performance, in our view. We reiterate our preference for Infosys (INFO IN, INR2746.55, Buy) over TCS driven by 1) a reversal in the trend of revenue growth outperformance at TCS vs Infosys; and 2) a widening of Infosys' margin lead over TCS, which we believe is likely to persist going forward. We expect Street expectations on TCS to be toned down on disappointments on the pricing front given two consecutive quarters of declines (contrary to management's previous expectation).

In-line results; commentary still upbeat

TCS reported USD revenue growth of 4.7% (vs consensus estimate of 5.5%), EBIT margin improvement of 90bps (vs consensus of 120bps) and PAT of INR24.4bn (vs consensus of INR25.3bn). We believe the results per se were strong, with 6.2% volume growth and 10 large deals signings each in excess of USD100mn+. Management continues to be upbeat on demand, with no warning bells so far.

Catalysts: Economic uncertainty shifting to individual clients and management commentary turning less upbeat on demand

Valuation: Reiterate Neutral; TP raised to INR1100 on roll forward

We expect a USD revenue CAGR of 19% and an EPS CAGR of 15% over FY11-13F. Our estimates remain largely unchanged post results. We raise our TP to INR1100 based on 18x one-year-forward earnings (unchanged). We find the stock fairly valued and see limited upside triggers.

31 Mar	FY11	FY12F		FY13F		FY14F	
Currency (INR)	Actual	Old	New	Old	New	Old	New
Revenue (mn)	373,245	465,259	472,295	518,526	520,204	596,807	600,757
Reported net profit (mn)	87,166	102,340	102,852	116,175	115,946	128,225	131,313
Normalised net profit (mn)	87,166	102,340	102,852	116,175	115,946	128,225	131,313
Normalised EPS	44.54	52.29	52.55	59.36	59.24	65.51	67.09
Norm. EPS growth (%)	27.0	17.4	18.0	13.5	12.7	10.4	13.3
Norm. P/E (x)	25.2	N/A	21.3	N/A	18.9	N/A	16.7
EV/EBITDA (x)	19.4	16.0	15.5	14.0	13.8	12.6	12.1
Price/book (x)	8.6	N/A	7.2	N/A	5.8	N/A	4.7
Dividend yield (%)	1.2	N/A	1.5	N/A	1.7	N/A	1.7
ROE (%)	37.6	35.8	36.9	32.8	34.1	29.6	31.3
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash	net cash	net cash

Source: Nomura estimates

Key company data: *See page 2 for company data and detailed price/index chart.*

Anchor themes

We believe it's prudent to participate in the sector through companies focused on market share gains, having low client concentration and better operating scope in the current uncertain economic environment.

Nomura vs consensus

Our FY13F earnings forecast is ~3% lower than Bloomberg consensus, as we factor in higher risk for growth amid the economic uncertainty and high BFSI/Europe exposure.

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See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

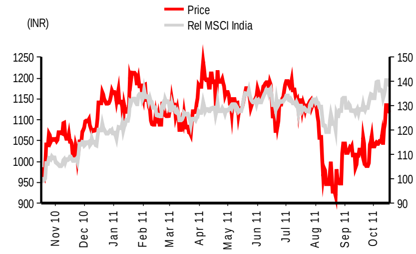
Key data on Tata Consultancy Services

Income statement (INRmn)

Year-end 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
Revenue	**300,289**	**373,245**	**472,295**	**520,204**	**600,757**
Cost of goods sold	-163,805	-205,865	-259,262	-286,138	-339,337
Gross profit	**136,484**	**167,380**	**213,034**	**234,065**	**261,420**
SG&A	-56,975	-62,609	-83,094	-91,945	-103,049
Employee share expense					
Operating profit	**79,509**	**104,771**	**129,940**	**142,120**	**158,371**
EBITDA	**86,800**	**111,985**	**139,048**	**152,358**	**169,634**
Depreciation	-7,291	-7,214	-9,108	-10,238	-11,263
Amortisation					
EBIT	79,509	104,771	129,940	142,120	158,371
Net interest expense					
Associates & JCEs					
Other income	2,255	5,324	6,291	9,691	13,396
Earnings before tax	**81,764**	**110,095**	**136,231**	**151,811**	**171,767**
Income tax	-12,088	-21,739	-32,386	-34,916	-39,506
Net profit after tax	**69,676**	**88,356**	**103,844**	**116,894**	**132,261**
Minority interests	-1,019	-1,190	-992	-948	-948
Other items	-10	0	0	0	0
Preferred dividends					
Normalised NPAT	**68,647**	**87,166**	**102,852**	**115,946**	**131,313**
Extraordinary items	0	0	0	0	0
Reported NPAT	**68,647**	**87,166**	**102,852**	**115,946**	**131,313**
Dividends	-45,797	-32,058	-38,927	-43,507	-43,507
Transfer to reserves	**22,850**	**55,108**	**63,925**	**72,439**	**87,805**
Valuation and ratio analysis					
FD normalised P/E (x)	31.9	25.2	21.3	18.9	16.7
FD normalised P/E at price target (x)	29.9	23.6	20.0	17.7	15.7
Reported P/E (x)	31.9	25.2	21.3	18.9	16.7
Dividend yield (%)	1.8	1.2	1.5	1.7	1.7
Price/cashflow (x)	74.3	18.8	24.5	20.0	18.7
Price/book (x)	10.4	8.6	7.2	5.8	4.7
EV/EBITDA (x)	25.1	19.4	15.5	13.8	12.1
EV/EBIT (x)	27.4	20.8	16.6	14.8	12.9
Gross margin (%)	45.5	44.8	45.1	45.0	43.5
EBITDA margin (%)	28.9	30.0	29.4	29.3	28.2
EBIT margin (%)	26.5	28.1	27.5	27.3	26.4
Net margin (%)	22.9	23.4	21.8	22.3	21.9
Effective tax rate (%)	14.8	19.7	23.8	23.0	23.0
Dividend payout (%)	66.7	36.8	37.8	37.5	33.1
Capex to sales (%)	3.6	4.5	3.9	3.7	3.3
Capex to depreciation (x)	1.5	2.3	2.0	1.9	1.8
ROE (%)	37.5	37.6	36.9	34.1	31.3
ROA (pretax %)	33.3	36.3	38.4	37.4	38.0
Growth (%)					
Revenue	8.0	24.3	26.5	10.1	15.5
EBITDA	20.9	29.0	24.2	9.6	11.3
EBIT	20.4	31.8	24.0	9.4	11.4
Normalised EPS	33.6	27.0	18.0	12.7	13.3
Normalised FDEPS	33.6	27.0	18.0	12.7	13.3
Per share					
Reported EPS (INR)	35.07	44.54	52.55	59.24	67.09
Norm EPS (INR)	35.07	44.54	52.55	59.24	67.09
Fully diluted norm EPS (INR)	35.07	44.54	52.55	59.24	67.09
Book value per share (INR)	107.49	130.31	155.74	192.75	237.61
DPS (INR)	20.00	14.00	17.00	19.00	19.00

Source: Nomura estimates

Relative performance chart (one year)



Source: ThomsonReuters, Nomura research

(%)	1M	3M	12M
Absolute (INR)	9.0	-2.3	17.9
Absolute (USD)	5.3	-11.1	6.2
Relative to index	8.0	6.2	35.3
Market cap (USDmn)	44,792.2		
Estimated free float (%)	23.0		
52-week range (INR)	1247/902		
3-mth avg daily turnover (USDmn)	50.56		
Major shareholders (%)			
Tata Sons Ltd	73.8		

Source: Thomson Reuters, Nomura research

Notes

We expect USD revenue growth of 25.1%/12.9% for FY12/13F

Cashflow (INRmn)

Year-end 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
EBITDA	86,800	111,985	139,048	152,358	169,634
Change in working capital	-44,271	27,556	-16,201	-6,621	-12,211
Other operating cashflow	-13,035	-22,929	-33,378	-35,864	-40,454
Cashflow from operations	**29,494**	**116,612**	**89,468**	**109,872**	**116,969**
Capital expenditure	-10,932	-16,934	-18,243	-19,200	-20,000
Free cashflow	**18,561**	**99,678**	**71,225**	**90,672**	**96,969**
Reduction in investments	-20,546	-53,005	-2,577	0	0
Net acquisitions					
Reduction in other LT assets	5,706	-3,266	-4,195	-6,193	-7,713
Addition in other LT liabilities	0	0	0	0	0
Adjustments	1,160	-1,946	-1,006	-570	-570
Cashflow after investing acts	**4,882**	**41,461**	**63,447**	**83,909**	**88,686**
Cash dividends	-45,797	-32,058	-38,927	-43,507	-43,507
Equity issue	30,864	-11,354	-12,722	0	0
Debt issue	4,605	1,919	1,075	1,285	2,088
Convertible debt issue	0	0	0	0	0
Others	2,255	5,322	6,291	9,691	13,396
Cashflow from financial acts	**-8,073**	**-36,171**	**-44,283**	**-32,531**	**-28,023**
Net cashflow	**-3,191**	**5,290**	**19,164**	**51,378**	**60,664**
Beginning cash	13,440	10,249	15,539	34,703	86,081
Ending cash	10,249	15,539	34,703	86,081	146,744
Ending net debt	-10,249	-15,539	-34,703	-86,081	-146,744

Source: Nomura estimates

Notes

Cash flow generation remains strong

Balance sheet (INRmn)

As at 31 Mar	FY10	FY11	FY12F	FY13F	FY14F
Cash & equivalents	10,249	15,539	34,703	86,081	146,744
Marketable securities	37,799	90,821	93,398	93,398	93,398
Accounts receivable	70,109	95,497	129,520	143,312	165,726
Inventories	0	0	0	0	0
Other current assets	59,762	14,485	15,816	17,500	20,237
Total current assets	**177,919**	**216,342**	**273,438**	**340,291**	**426,106**
LT investments	17	0	0	0	0
Fixed assets	41,706	51,996	61,701	71,233	80,540
Goodwill	32,415	33,791	34,227	34,227	34,227
Other intangible assets	0	0	0	0	0
Other LT assets	22,488	25,754	29,949	36,142	43,855
Total assets	**274,546**	**327,883**	**399,314**	**481,893**	**584,727**
Short-term debt					
Accounts payable	50,996	58,663	77,816	86,670	99,611
Other current liabilities					
Total current liabilities	**50,996**	**58,663**	**77,816**	**86,670**	**99,611**
Long-term debt					
Convertible debt					
Other LT liabilities	9,110	11,029	12,104	13,390	15,478
Total liabilities	**60,106**	**69,692**	**89,920**	**100,060**	**115,089**
Minority interest	4,056	3,147	4,581	4,581	4,581
Preferred stock	1,000	1,000	1,000	1,000	1,000
Common stock	1,957	1,957	1,957	1,957	1,957
Retained earnings	207,427	252,087	301,856	374,295	462,100
Proposed dividends					
Other equity and reserves					
Total shareholders' equity	**210,384**	**255,044**	**304,813**	**377,252**	**465,058**
Total equity & liabilities	**274,546**	**327,883**	**399,314**	**481,893**	**584,727**
Liquidity (x)					
Current ratio	3.49	3.69	3.51	3.93	4.28
Interest cover	na	na	na	na	na
Leverage					
Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Activity (days)					
Days receivable	88.4	81.0	87.2	95.7	93.9
Days inventory	0.0	0.0	0.0	0.0	0.0
Days payable	125.6	97.2	96.3	104.9	100.2
Cash cycle	-37.2	-16.2	-9.1	-9.2	-6.3

Source: Nomura estimates

Notes

Cash levels are on the rise

In-line results in both absolute and relative terms

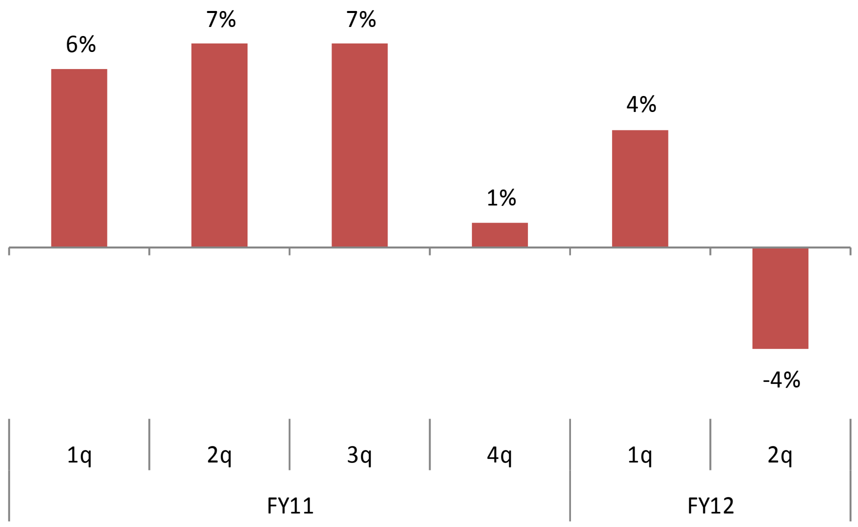
TCS reported USD revenue growth of 4.7% q-q (vs our estimate of 5.4%), EBIT margin improvement of 90bps (in line) and PAT was INR24.4bn (vs our estimate of INR24.6).

On a relative basis (compared to Infosys), TCS results were again in line with our expectations of 1) smaller outperformance to Infosys in q-q USD revenue growth compared to the previous two quarters and 2) lower margin expansion than Infosys. TCS outperformance to Infosys in q-q USD revenue growth narrowed from 3ppt in the previous two quarters to 0.2ppt in 2Q. Also, EBIT margins improved by 90bps q-q at TCS compared to 210bps at Infosys in 2Q.

Consensus outperformance ends after five quarters

TCS's 2Q results missed on consensus PAT expectations after five quarters of outperformance. We believe the miss could likely weigh on stock price performance in the near term.

Fig. 1: Trend of TCS's earnings outperformance (%) over consensus expectations
TCS misses consensus earnings by 4% in 2QFY12 after 5 quarters of outperformance



Source: Bloomberg, Nomura research

Pricing declines a key disappointment

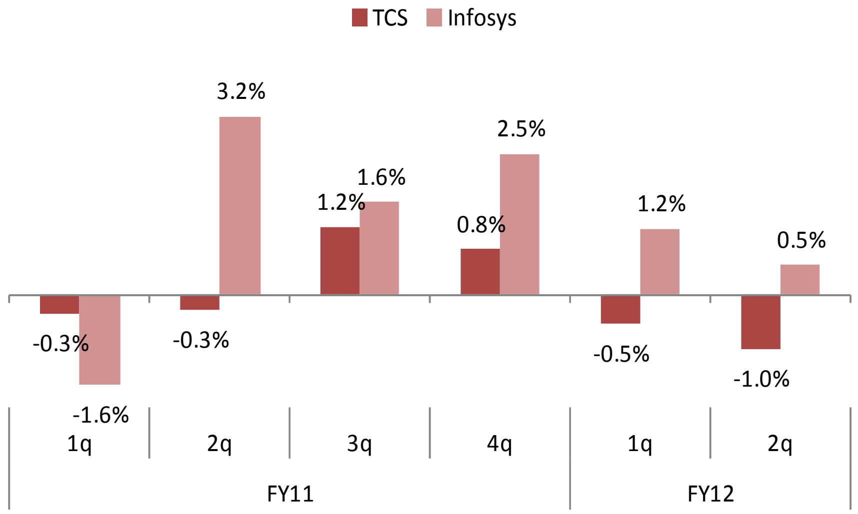
Pricing declined by ~1% in 2QFY12 on the back of 0.5% decline in the previous quarter. We believe the Street will likely be disappointed by the performance on the pricing front, as TCS management had been guiding for an upward bias in pricing in the previous two quarters. Management has changed its stance this quarter and expects pricing to be stable going forward, with no hope of any increase.

Decline in FPP mix key reason for pricing decline, however mitigating factors plenty

The 290bps q-q decline in the fixed-price mix in 2Q was cited as one of the reasons for the ~1% pricing decline. However, factors that could have aided pricing growth, too, were present, including: 1) a 4% q-q decline in India business, which is a lower-realization business, compared to International business, which grew by 9% q-q in rupee terms; and 2) strong growth in high-realization service lines such as Enterprise solutions (8% q-q in USD terms) and Products (16% q-q in USD terms). In contrast, Infosys delivered 0.5% blended growth in pricing on a sequential basis (1% on constant-currency pricing) aided by a robust 3.5% pricing increase in offshore on a constant-currency basis.

Fig. 2: TCS vs Infosys: pricing growth (%) trend

TCS has seen pricing declines over the past 2 quarters despite guiding for an upward bias



Note: Pricing growth for Infosys is based on IT Services and Consulting, while for TCS is at the consolidated level

Source: Company data, Nomura research

Fig. 3: TCS management commentary on pricing in the past 3 quarters

TCS commentary on pricing increases has turned from certainty (in 4QFY11) to unlikelihood (in 2QFY12)

Quarter	Management commentary on pricing
2QFY12	*Pricing will be stable, very difficult to get pricing increases*
1QFY12	*We do expect to see some pricing uptick, but it is getting delayed. It is not coming in as expected for various reasons, but I do think that sometime in this fiscal year we should see an uptick, maybe the later part.*
4QFY11	*Going forward we continue to expect some pricing improvement in the next fiscal year, because customers are not only focused on cost, they are increasingly focusing on value, which should drive significant number of projects due discretionary spend in the coming year.*

Note: Excerpts taken from earnings transcript

Source: Company data, Nomura research

Results per se positive, management commentary upbeat

We found TCS results to be positive, although it may not have met heightened Street expectations. The key highlights for the quarter are:

- Volume growth of 6.25% and revenue growth of 6% q-q in the International business (92% of revenues) in USD terms.
- 10 deals signed in 2Q, with each deal having total contract value in excess of USD100mn. These deals were won across all major verticals and split evenly across US and Europe.
- TCS is currently chasing 10 large deals – again, across all major verticals.
- Management commentary: Robust pipeline, deal signings on track, no red flags raised by any client yet.

- Three large deals signed in Telecom vertical – management is optimistic about growth in this vertical in 3Q on the back of these deals (in 2Q, Telecom revenues declined by 4% q-q in USD terms).

No material changes to our estimates

Our USD revenue estimates remain largely unchanged, and we look for 25.1%/12.9% revenue growth in FY12/13F. We have slightly increased our EBITDA margin estimates for FY12F on a higher USD/INR rate assumption. Tax rates assumption has gone up marginally in line with management guidance.

Over FY11F-13F, we expect USD-denominated revenue to record a CAGR of 19%, an EPS CAGR of 15% and an EBITDA margin decline of 70bps.

Fig. 4: Earnings revision

	New		Old		Change (%)	
	FY12F	FY13F	FY12F	FY13F	FY12F	FY13F
Revenue (US$ mn)	10,242	11,560	10,248	11,523	-0.1	0.3
US$/INR rate	46.1	45.0	45.4	45.0	1.6	0.0
Revenue (Rs bn)	472.3	520.2	465.3	518.5	1.5	0.3
EBITDA margin (%)	29.4	29.3	28.9	29.1	50 bps	20 bps
Tax Rate (%)	23.8	23.0	22.9	22.5	80 bps	50 bps
Diluted EPS (Rs)	52.6	59.2	52.3	59.4	0.5	-0.2

Source: Nomura estimates

Maintain Neutral; reiterate preference for Infosys over TCS

We maintain our Neutral rating on TCS and reiterate our preference for Infosys over TCS driven by 1) a reversal in the trend of revenue growth outperformance at TCS vs Infosys; and 2) a widening of Infosys' margin lead over TCS and likely sustenance going forward. We find the stock fairly valued and see limited upside triggers.

Revenue growth outperformance of TCS over Infosys likely to reverse next quarter

We expect TCS's revenue growth outperformance over Infosys possibly reversing from next quarter onwards as Infosys starts to gain in momentum post the recent organizational restructuring and lower exposure to Europe/BFSI, the first segment to be impacted by the slowdown. Also, Infosys has guided for an evenly spread out FY12F in terms of sequential revenue growth. Typically, 3Q is a weak quarter compared to 2Q for IT companies on account of fewer working days (due to the holiday season) and client shutdowns. However, Infosys has guided for 5.4% q-q revenue growth in 3Q at the top end – higher than the 4.5% q-q growth it achieved in 2Q. TCS management expects the seasonal weakness in 3Q to play out – confirming our view that Infosys can outperform TCS in 3Q.

Infosys margin lead over TCS likely to sustain

We expect better operational performance at Infosys over TCS in 3Q and going forward, given what we view as the better operational scope at Infosys.

We increase our TP, based on 18x one-year-forward earnings (unchanged) increases to INR1,100 (vs INR1,070 previously) on our roll-forward of earnings.

2QFY12 result highlights

– USD revenue growth was below expectations at 4.7% q-q compared with our and consensus estimate of 5.4% (and in line with Infosys at 4.5% q-q after significant outperformance over the past few quarters)

– Revenue at INR 116.3bn was in line with consensus and our expectation

– EBIT margin at 27.1%, up 90bps, was in line with our estimate and below consensus expectation of +120 bps

– PAT at INR 24.4bn was below our estimate of 24.6bn and consensus of 25.3bn, 2.5% growth q-q

– Headcount increased by 12,580 employees (6.2% q-q growth)

– Attrition declined by 110bps to 13.7% (on a LTM basis, excluding subsidiaries)

Fig. 5: TCS 2QFY12: Actual vs expected

Key parameters	2QFY12		1QFY12	q-q (%)	2QFY11	y-y (%)
	Actual	Estimate				
Revenues (US$ mn	2,525	2,542	2,412	4.7	2,004	26.0
Revenues (Rs mn)	116,335	116,433	107,970	7.7	92,864	25.3
EBITDA (Rs mn)	33,829	33,655	30,310	11.6	27,775	21.8
EBITDA margin (%)	29.1	28.9	28.1	100bps	29.9	-80bps
PAT (Rs mn)	24,390	24,584	23,803	2.5	21,262	14.7
EPS (Rs)	12.5	12.6	12.2	2.5	10.9	14.7

Source: Company data, Nomura estimates

Segmental performance

- Growth was broad-based, with BFSI (5% q-q), Manufacturing (7% q-q), Retail (9% q-q) and Energy & Utilities (18% q-q) leading. Telecom declined by 4% q-q.
- TCS grew by 6% q-q in the US, 6% q-q in the UK and 7% q-q in Continental Europe, while India underperformed the company's overall growth significantly with a 7% q-q decline.
- Among service lines, Enterprise solutions (+8% q-q), Infrastructure services (+6% q-q) and Products (+16% q-q) were the leaders. Application development and maintenance had a muted quarter with 1% q-q growth.

Fig. 6: Quarterly performance and expectations

Y/E MARCH	FY11				FY12				FY11	FY12F
Rs mn	1Q	2Q	3Q	4Q	1Q	2Q	3QF	4QF		
Revenues (US$ mn)	**1,794**	**2,004**	**2,144**	**2,244**	**2,412**	**2,525**	**2,614**	**2,692**	**8,186**	**10,248**
q-q change %	*6.4*	*11.7*	*7.0*	*4.7*	*7.5*	*4.7*	*3.5*	*3.0*	*29.1*	*25.2*
Revenues	**82,173**	**92,864**	**96,633**	**101,575**	**107,970**	**116,335**	**124,172**	**123,819**	**373,245**	**465,259**
q-q change %	*6.2*	*13.0*	*4.1*	*5.1*	*6.3*	*7.7*	*6.7*	*-0.3*	*24.3*	*24.7*
Direct Expenses	44,129	49,956	51,502	53,786	58,791	62,141	65,228	64,904	199,372	251,190
SG&A Expenses	13,889	15,133	15,957	16,909	18,869	20,365	21,429	21,519	61,888	79,537
EBITDA	**24,155**	**27,775**	**29,174**	**30,880**	**30,310**	**33,829**	**37,514**	**37,395**	**111,985**	**134,531**
EBITDA margin (%)	*29.4*	*29.9*	*30.2*	*30.4*	*28.1*	*29.1*	*30.2*	*30.2*	*30.0*	*28.9*
Other Income	820	443	1,822	2,239	2,886	997	1,052	1,356	5,324	8,362
Depreciation	1,575	1,660	1,856	2,123	2,049	2,286	2,390	2,383	7,216	8,656
PBT	**23,400**	**26,558**	**29,140**	**30,996**	**31,147**	**32,540**	**36,176**	**36,367**	**110,093**	**134,237**
Provision for Tax	4,475	5,001	5,491	6,772	7,063	7,913	8,682	8,728	21,739	30,774
Tax rate (%)	*19.1*	*18.8*	*18.8*	*21.8*	*22.7*	*24.3*	*24.0*	*24.0*	*19.7*	*22.9*
Minority Interest	292	295	189	415	281	237	237	237	1,190	1,124
PAT	**18,633**	**21,262**	**23,460**	**23,809**	**23,803**	**24,390**	**27,257**	**27,402**	**87,164**	**102,340**
q-q change %	*-3.5*	*14.1*	*10.3*	*1.5*	*0.0*	*2.5*	*11.8*	*0.5*	*26.8*	*17.4*
Diluted EPS (Rs)	**9.5**	**10.9**	**12.0**	**12.2**	**12.2**	**12.5**	**13.9**	**14.0**	**44.5**	**52.3**

Source: Company data, Nomura research

Fig. 7: Sequential growth matrix

q-q growth (%)	2QFY11	3QFY11	4QFY11	1QFY12	2QFY12
Service Lines					
ADM	9%	3%	7%	8%	1%
Business Intelligence	16%	1%	-3%	7%	0%
Engineering and Industrial Services	14%	5%	5%	3%	9%
Infrastructure Services	21%	20%	-9%	12%	6%
Enterprise Solutions	17%	0%	18%	7%	8%
Global Consulting	12%	17%	-4%	13%	24%
Asset Leverage Solutions	3%	26%	-6%	7%	16%
Assurance Services	15%	15%	3%	12%	9%
BPO	9%	12%	7%	1%	5%
Industry Verticals					
BFSI	10%	8%	3%	6%	5%
Manufacturing	12%	4%	9%	9%	7%
Telecom	13%	-1%	-3%	14%	-4%
Life Sciences & Healthcare	10%	9%	7%	5%	7%
Retail & Distribution	11%	7%	8%	11%	9%
Transportation	15%	14%	20%	2%	8%
Energy and Utilities	46%	9%	9%	-11%	18%
Media & Entertainment	18%	23%	5%	3%	0%
Hi-Tech	12%	16%	13%	15%	7%
Geographies					
America	9%	7%	4%	6%	6%
UK	13%	12%	1%	6%	6%
Rest of Europe	14%	9%	11%	7%	7%
Europe	14%	11%	5%	7%	6%
India	26%	-1%	0%	14%	-7%
APAC	17%	19%	9%	9%	8%
Ibero America	1%	-15%	8%	4%	1%
MEA	6%	13%	5%	18%	5%

Source: Company data, Nomura research

Scenario analysis: What if the US and Europe slip back into recession?

As the markets have been signaling that risks to our baseline forecasts are on the downside, our global economics team have considered a bear case economic scenario, most obviously triggered by a market meltdown, but the fragile state of the advanced economies leaves them vulnerable to unforeseen shocks or policy errors. For details, see Global Weekly Economic Monitor, 12 August 2011, and Global market turbulence: Implications for Asia, 9 August 2011.

The bear case scenario assumes:

- The US and Euro area slip back into recession, with US GDP averaging -1% saar in 2H11 and Euro GDP averaging -3% before recovering to around 2% growth in 2012.
- The CRB commodity price index falls 15% between now and year-end, but starts rising back again through 2012 reaching current levels by end-2012.

If there is a market meltdown and recessions in the US and euro area, we have no doubt that initially many economies in the region would be hit hard again in an echo of the global financial crisis, as non-linear effects start to kick in, notably financial decelerator effects, multiplier effects of weakening exports on domestic capex and jobs, and capital flight. However, less disturbing this time around are the two factors that there is less leverage in the financial system (less room for capital flight) and less chance of Asian trade finance drying up, as the world's central banks have most likely learnt the need to provide ample USD liquidity through FX swap arrangements.

In this scenario, we find Hong Kong, Singapore, Malaysia and Taiwan to be among the most vulnerable. But, as in 2009, we would expect that, over time, powerful tailwinds would develop, allowing Asia to bounce back before other regions. These tailwinds include a likely further decline in commodity prices and the ample room Asia has to ease monetary and fiscal policies – more so than any other region. In our bear case scenario, we would expect the Fed to resort to further quantitative easing, which once again would likely precipitate strong net capital inflows into Asia, attracted by stronger growth, superior fundamentals and higher interest rates relative to other regions.

What if things get even worse than we can foresee? Although our global economics team does not see such a situation as plausible at the moment, they have run an extreme-case scenario analysis to provide some perspective. This extreme scenario assumes:

- US GDP averaging about -4% saar in 2H11 and Euro GDP averaging -6.5% before recovering to around 1% growth in 2012.
- CRB commodity price index falls 40% between now and year-end, and stays at the lower level through 2012.

The table below summarises both the official bear case and the hypothetical extreme case scenarios.

Fig. 8: Real GDP growth forecasts: baseline and downside scenarios

	2011F			2012F		
	Base case	**Bear case**	**Extreme case**	**Base case**	**Bear case**	**Extreme case**
Australia	2.2	1.5	0.9	4.6	3.5	3.3
China	9.5	9.0	8.5	8.6	8.8	6.0
Hong Kong	5.4	4.4	3.4	4.5	4.0	1.2
India	7.7	7.0	6.5	7.9	7.6	7.0
Indonesia	6.5	6.0	4.8	7.0	6.8	4.0
Malaysia	4.7	4.0	1.0	5.1	4.8	-0.4
New Zealand	2.2	1.8	1.4	3.5	3.5	3.3
Philippines	5.1	4.7	3.3	5.7	5.3	2.4
Singapore	4.8	4.3	1.5	5.3	5.1	-1.8
South Korea	3.5	2.5	1.5	5.0	5.0	2.5
Taiwan	4.5	3.6	2.4	5.0	4.9	0.9
Thailand	4.1	3.5	0.6	4.7	4.5	-0.5
Vietnam	6.4	6.0	4.5	6.9	6.5	4.2
Asia ex Japan, Aus, NZ	7.8	7.2	6.4	7.6	7.6	5.1

Source: CEIC and Nomura Global Economics. Units: % y-o-y

The global bear case does not look bad for much of Asia and in fact is marginally better than the base case for China in 2012 because we would expect a V-shape rebound for the region thanks to the likely decline in commodity prices and the ample room Asia has to ease monetary and fiscal policies. We would also expect the Fed to resort to further quantitative easing, which once again would likely precipitate strong net capital inflows into Asia. In the extreme case, however, even these strengths will be tested.

What does this mean for our companies?

In the above-mentioned bear case scenario, we have assumed a 1% pricing cut in the quarter ending March 2012, followed by a 4% cut in the quarter ending June 2012. Under the extreme scenario, we have assumed a 2% pricing cut in the quarter ending March 2012, followed by an 8% cut in the quarter ending June 2012. We have assumed 10%/20% de-rating in P/E multiples in the bear case/extreme case scenarios, respectively.

Fig. 9: Earnings and Price target sensitivity

	Base case	Bear case	Downside %	Extreme case	Downside %
TCS					
FY12F EPS	53	52	-1%	52	-2%
FY13F EPS	59	51	-14%	42	-28%
12-m target price	1100	860	-22%	630	-43%

Source: Nomura estimates

Appendix A-1

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Mentioned companies

Issuer name	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Infosys	INFO IN	INR 2746	17-Oct-2011	Buy	Not rated	123
Tata Consultancy Services	TCS IN	INR 1120	17-Oct-2011	Neutral	Not rated	

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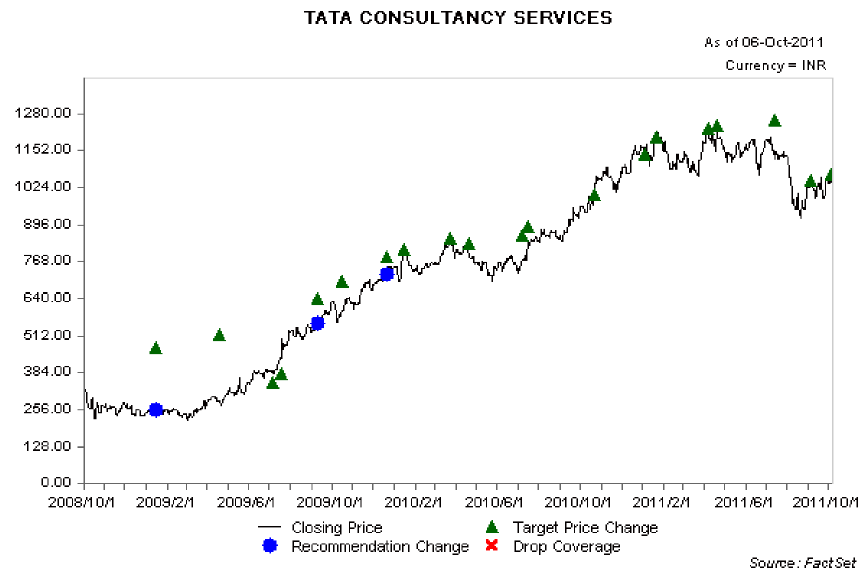
Issuer name	Previous Rating	Date of change
Infosys	Neutral	21-Jan-2011
Tata Consultancy Services	Buy	22-Dec-2009

Tata Consultancy Services (TCS IN) **INR 1120 (17-Oct-2011)** Neutral (Sector rating: Not rated)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
04-Oct-2011		1070.00	1045.95
05-Sep-2011		1050.00	1027.80
14-Jul-2011		1260.00	1125.25
21-Apr-2011		1240.00	1191.65
08-Apr-2011		1230.00	1194.90
21-Jan-2011		1200.00	1212.60
05-Jan-2011		1140.00	1158.05
22-Oct-2010		1000.00	1040.10
16-Jul-2010		890.00	832.40
08-Jul-2010		860.00	776.60
20-Apr-2010		830.00	789.60
25-Mar-2010		850.00	829.30
15-Jan-2010		810.00	791.80
22-Dec-2009		785.00	724.10
22-Dec-2009	Neutral		724.10
17-Oct-2009		700.00	599.00
10-Sep-2009		640.00	556.40
10-Sep-2009	Buy		556.40
20-Jul-2009		383.00	500.10
06-Jul-2009		349.00	381.60
20-Apr-2009		517.00	280.20
15-Jan-2009		469.00	255.00
15-Jan-2009	Reduce		255.00

For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology Our target price of INR1,100 is based on 18x our FY13F earnings forecast of INR62. Our target multiple is in line with the stock's historical average, reflecting heightened economic uncertainties and risk on its high BFSI and Europe exposure.

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