Equity Research

December 8, 2008

BSE Sensex: 8965

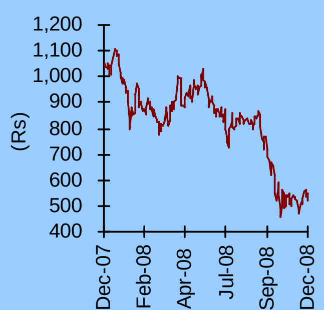
Technology

Shareholding pattern

	Mar '08	Jun '08	Sep '08
Promoters	77.6	76.4	76.4
Institutional investors	16.2	17.5	17.6
MFs and UTI	1.3	2.1	1.8
Insurance Cos.	4.1	4.3	4.7
FIIs	10.8	11.2	11.1
Others	6.2	6.1	6.1

Source: www.nseindia.com

Price chart



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INDIA

Tata Consultancy Services

HOLD
Maintained

Spotlight on margins

Rs522

Reason for report: Management meet

Post our recent meeting with the management of Tata Consultancy Services (TCS), it is clear that the focus is shifting towards profitable growth and margins. We believe the main margin lever is offshore revenue contribution as sustainable improvement in utilisation will be difficult in FY09 & FY10 and flexibility in employee cost will be capped, at least for FY09 – we expect lower wage inflation in FY10 to reduce margin pressure. Despite expected improvement in H2FY09 EBITDA margin, we believe hedging loss may limit the positive surprise on FY09 EPS front. Overall, the management is cautious on BFSI demand and decision lag continues within large deals. We expect volume growth to be significantly lower in the coming quarters versus ~6% in Q2FY09 with cross-currency volatility pressurising dollar revenue growth. We maintain HOLD on TCS given challenging demand outlook with target price of Rs615. The worst as regards client-specific risks in BFSI may be over. However, non-BFSI client related risk, especially in Auto, may lead to additional pressure on sales though EPS visibility is improving.

- **BFSI – Growth still muted.** Factors such as: i) discretionary cuts post the BFSI crisis, ii) capital markets and insurance under strain and iii) despite free transition being over, continued underperformance in BFSI will affect growth.
- **Non-BFSI ramp-up still continues; Auto remains a concern.** Volume growth is mainly owing to ramp-up of earlier deals – Manufacturing, Retail and Pharma/Healthcare are growing versus Telecom. Further, client-specific risks in the Auto vertical are another area of concern besides BFSI.
- **CY09 IT budget under strain; pricing outlook flat; FY09 recruitment target might be missed.** TCS expects CY09 budget to be finalised by January '09 as opposed to Infosys' expectations of March '09. However, the TCS management expects IT services' budgets to reduce with higher outsourcing and offshoring. At present, TCS is denying price cut requests; instead, it is pitching for higher fixed price/non-linear and offshoring. Thus, the company expects pricing to be flat without major undercutting. With challenging macroeconomic environment leading to forced holidays in December '08 across verticals, TCS may limit the gross recruitment to 27,000-28,000 versus its FY09 guidance of 30,000-35,000. However, the company will honour its 24,500 campus offers for FY10E.

Market Cap	Rs988bn/US$10.5bn
Reuters/Bloomberg	TCS.BO/TCS.IN
Shares Outstanding (mn)	978.61
52-week Range (Rs)	1,109/454
Free Float (%)	23.6
FII (%)	11.1
Daily Volume (US$'000)	25,000
Absolute Return 3m (%)	(39.1)
Absolute Return 12m (%)	(49.6)
Sensex Return 3m (%)	(40.0)
Sensex Return 12m (%)	(54.7)

Year to March*	FY08	FY09E	FY10E	FY11E
Revenue (Rs mn)	228,615	287,348	301,888	345,387
Net Income (Rs mn)	49,899	57,598	61,592	67,158
EPS (Rs)	51.0	58.9	62.9	68.6
% Chg YoY	22.5	15.4	6.9	9.0
P/E (x)	10.2	8.9	8.3	7.6
CEPS (Rs)	54.4	61.6	66.1	75.6
EV/E (x)	8.2	6.2	5.6	4.7
Dividend Yield (%)	2.5	2.8	3.0	3.3
RoCE (%)	43.9	38.1	31.9	28.1
RoE (%)	46.7	39.9	33.1	29.0

* financials estimates excluding CGSL

Increasing focus on margins

- **TCS reluctant to agree to price cut requests, including token discounts.** Despite some clients demanding price cuts so as to reduce their IT budgets, at present TCS is reluctant to accept such requests, but will provide leverage to clients in terms of higher offshoring and converting time and material (T&M) to fixed-price contracts. Also, as per TCS, there has been insignificant undercutting versus Infosys' contrarian view in some deals (refer our report '*Slowdown spreads beyond BFSI*' dated December 2, '08). This may be due to Infosys' premium pricing.

- **Higher focus on increasing flexibility of employees cost.** TCS' employee cost is ~72% of the total operational cost (including depreciation) versus Infosys' ~73%. This is despite TCS' onsite revenue proportion (of international revenues, which is ~92% of consolidated revenues) being +4% higher than Infosys'. Also, the number of employees with less than three years experience is +5% higher for Infosys versus TCS. The gap in employee cost ratio could be partly due to TCS' higher Q2FY09 utilisation (including trainees) at 74.7% versus Infosys' 69.4% and higher proportion of TCS' revenues coming from leased premises. However, the lower gap also indicates low variable portion in TCS' employee-related cost. In FY10, TCS will focus on increasing the flexibility in employee cost. We believe that significantly increasing the variable portion within cost to company (CTC) may not be fully possible for TCS even in FY10. Therefore, likely lower wage inflation in FY10 will reduce margin pressure. The management is even evaluating wage inflation of less than 8% in FY10 for offshore employees. To significantly increase the variable portion in FY10 CTC, we believe that TCS' wage inflation should be higher than peers. Also, in FY10, the promotion of employees is likely to be under tight control.

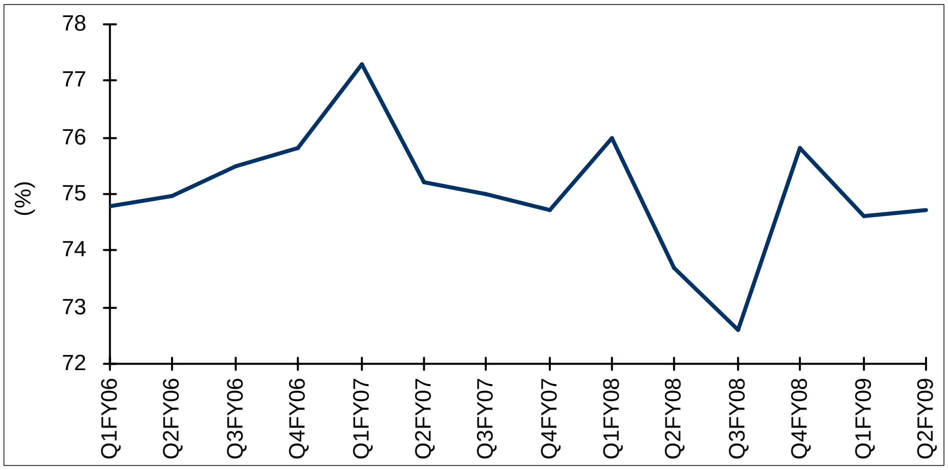
Table 1: Employee cost parameters comparison

FY08	TCS	Infosys
Onsite Revenues (%)*	53.9	48.4
Utilisation Rates	75.8	70.0
Less than 3 years experience#	50.3	55.8
Employee cost to total cost (incl depreciation)	71.8	73.1

* TCS: Excluding domestic revenues for TCS; GDC/RDC not included in Onsite Infosys: Consolidated revenues
# Infosys: Employees 20 - 25 age profile assumed as less than three years experience
Source: Company data, I-Sec Research

- **Utilisation improvement possible but not sustainable.** With increasing intake of freshers during FY09 and 24,500 campus offers in FY10, improving utilisation (including trainees) on a sustainable basis will be challenging. With difficult macroeconomic environment, TCS may limit the gross recruitment to 27,000-28,000 versus its FY09 guidance of 30,000-35,000. However, the company will honour its 24,500 campus offers for FY10E.

Chart 1: Utilisation movement, including trainees



Source: Company data, I-Sec Research

BFSI – Growth still subdued

- **Free transition over.** With Q2FY09 revenue contribution from BFSI (including capital market operations at 12-14%) at 42% (down from 44% in Q3FY08), our discussion with the management indicated that free transition is behind for TCS.
- **Discretionary projects under pressure post crisis.** Post the continued free transition in some large BFSI client accounts, ramp-up of discretionary projects within BFSI is taking longer, which is pressurising growth.
- **Insurance – Some project cancellations seen.** We believe that Insurance contributes more than 10% to TCS' revenues. With sub-prime/credit crisis affecting some large insurance companies in the US (some are TCS' clients), unaffected insurance companies are also cautious in terms of ramp-ups. TCS is also witnessing project cancellations, though insignificant.

Thus, volume growth in BFSI is likely to be meek, affecting TCS' overall growth in coming quarters.

Non-BFSI ramp-up still continues; Auto remains a concern

- **Growth largely through earlier deals.** Volume growth in Manufacturing and Retail is still continuing, largely through ramp-ups in earlier deals. Pharma and Healthcare, however, continued to grow and Telecom's growth visibility has been muted.
- **Auto – New risks to revenues.** Within Manufacturing vertical, we believe that the contribution of Auto/Auto Ancillary is significant. Within Auto, TCS is exposed to some troubled auto majors from the US. We believe that the auto market (largely passenger vehicles) in the US is highly concentrated within few major players and any trouble for these majors would affect the overall industry (both Auto Ancillary and Auto financiers). Therefore, we believe that for TCS, growth within Auto may be at risk. As per the company, outsourcing by such auto majors is a recent phenomenon.

CY09 IT budget under pressure; pricing outlook flat

- **Forced holidays witnessed across verticals.** This time around TCS is witnessing higher number of holidays during December ’08 versus earlier years owing to forced holidays by some clients across verticals.
- **TCS expects CY09 IT services budgets to be cut** besides pressure on hardware and software budgets. Higher outsourcing and offshoring are also expected, implying some volume growth even in FY10.
- **Large deal pipeline unchanged; decision making cycle delayed.** Despite an impressive deal pipeline, decision making has been delayed from the earlier cycle of six months to nine months. There have been some requests for billing rate cuts, but TCS is pitching for higher fixed-price component (versus T&M) and increased offshoring.
- **TCS expects IT budget to be finalised by January ’09** versus Infosys’ expectations of March ’09. TCS is not expecting any major trend change versus that in CY08. Thus, we believe that the company’s Q3FY08 results may provide some indication in terms of FY10 growth outlook.
- **Pricing outlook flat.** Despite pricing pressure in IT budgets of some clients, TCS expects flat pricing to continue going forward. However, we expect pricing pressure to increase and result in pricing decline for vendors in FY10 (at present, we have factored in ~2% pricing decline).

Margins to improve, but hedging loss to continue

- **EBITDA margins to improve.** With continuing rupee depreciation and likely decline in provision for doubtful debts in Q3FY09 (55bps in Q2FY09), we expect margins to substantially increase (upside risk to our EPS estimates).
- **Q3FY09 & Q4FY09 hedge contracts significantly lower than current spot rates.** For Q3FY09, TCS has ~US$300mn and US$180mn worth contracts with Rs43.15-46.5 and Rs39-41.82 strike rates respectively (Q3FY09 average till date spot at ~Rs49.8/US$). Therefore, we believe that higher hedging loss (translation gain) in P/L account (though loss may decline QoQ) will likely continue in Q3FY09 (downside risk to our EPS estimates). Even for Q4FY09, outstanding contracts of ~US$190mn with average strike rate of ~Rs41.9 is likely to lead to continued hedging losses, though the losses will likely dip significantly QoQ if TCS does not add any more hedging covers.
- **Hedge position unchanged QoQ till date.** TCS has not taken any cover beyond the hedge position in Q2FY09. With the likely expiry of US$480mn worth hedge contracts in Q3FY09, we believe that OCI loss may not change materially from Q2FY09 levels.

Citicorp Global Services to consolidate effective Q4FY09

Integration of Citicorp Global Services (CGSL) with TCS is on track and the management expects CGSL to be consolidated from Q4FY09. Despite Citi Group’s ongoing restructuring/selling of various businesses, TCS does not expect any major risk to CGSL’s revenues from Citi (100% of CGSL’s revenues come from the Citi Group) considering the expected assurance from the buyer for continued business to CGSL. The management expects the treasury (cash, cash equivalent) in CGSL to be partly withdrawn by Citi Group, thus affecting short-term PAT margin. However, TCS expects CGSL's PAT margin to remain stable with cost synergies post acquisition (FY07 PAT at 20.3%). Note that our current estimates exclude CGSL.

Table 2: Impact of CGSL's consolidation on FY10 and FY11 estimates

(Rs mn)

	TCS Organic		TCS with CGSL		CGSL			
	FY10E	**FY11E**	**FY10E**	**FY11E**	**FY06**	**FY07**	**FY10E**	**FY11E**
Revenues (US$ mn)	**6,988**	**8,349**	**7,251**	**8,612**	**135**	**177**	**263**	**263**
% growth	***10.0***	***19.5***	***14.2***	***18.8***				
Average Rupee Dollar (Rs)	43.2	41.4	43.2	41.4	44.2	45.0	43.2	41.4
Revenues	301,888	345,387	313,250	356,266	5,966	7,936	11362	10880
% growth	*5.1*	*14.4*	*9.0*	*13.7*				
EBITDA	**75,079**	**84,252**	**77,749**	**86,809**	**1,196**	**1,957**	**2,670**	**2,557**
% to sales	***24.9***	***24.4***	***24.8***	***24.4***	***20.1***	***24.7***	***23.5***	***23.5***
Treasury Income (Post Tax)	3,799	5,207	2,565	4,045				
PAT	61,592	67,158	62,232	67,790	708	1,611	1,875	1,795
% to sales	*20.4*	*19.4*	*19.9*	*19.0*	*11.9*	*20.3*	*16.5*	*16.5*
EPS (Rs)	**62.9**	**68.6**	**63.6**	**69.3**				
% upgrade			***1.0***	***0.9***				

Source: Company data, I-Sec Research

I-Sec view

The key takeaway from our management meet is that TCS' focus has shifted to margin sustainability/improvement, which is important during the uncertain demand scenario. The main margin lever for TCS is offshore revenue contribution as sustained improvement in utilisation will be difficult in FY09 and FY10 and flexibility in direct cost will be capped at least in FY09. Despite expected EBITDA margin improvement in H2FY09, hedging loss may limit positive surprise on FY09 EPS front in our view. Even after lowering FY10 dollar revenue growth a second time, the downside to our revised dollar revenue growth exists (at present, FY10E dollar revenue growth estimated at 9-12% for large-caps). Our current FY09E & FY10E estimates for the average rupee-dollar rate at Rs45.3 and Rs43.2 are likely to contain the EPS downside.

We maintain HOLD on TCS given the challenging demand outlook with a target price of Rs615/share. We believe the worst as regards client-specific risks in BFSI may be over. However, non-BFSI client related risk (especially in Auto) may lead to additional pressure on sales, though EPS visibility is improving in our view.

Financial Summary (Consolidated US GAAP)

Table 3: Profit and Loss Statement

(Rs mn, year ending March 31)

	FY08	FY09E	FY10E	FY11E
Operating Revenues (Sales)	**228,615**	**287,348**	**301,888**	**345,387**
of which Exports	*208,117*	*264,226*	*276,018*	*314,317*
of which Domestic	*20,498*	*23,123*	*25,871*	*31,069*
Operating Expenses	**169,217**	**213,148**	**226,810**	**261,134**
EBITDA	**59,397**	**74,200**	**75,079**	**84,252**
% margins	*26.0*	*25.8*	*24.9*	*24.4*
Depreciation & Amortisation	5,746	5,398	6,302	7,253
Gross Interest	0	0	0	0
Other Income	4,450	(868)	4,065	7,243
Recurring PBT	**58,102**	**67,934**	**72,843**	**84,242**
Add: Extraordinaries	293	0	0	0
Less: Taxes	7787	9,805	10,654	16,413
- Current tax	*10,168*	*12,568*	*13,840*	*16,848*
- Deferred tax	*(2,381)*	*(2,763)*	*(3,186)*	*(435)*
Add: Earnings in Affiliates	8	(4)	(5)	(5)
Less: Minority Interest	424	526	592	666
Net Income (Reported)	**50,192**	**57,598**	**61,592**	**67,158**
Recurring Net Income	**49,899**	**57,598**	**61,592**	**67,158**

Source: Company data, I-Sec Research

Table 4: Balance Sheet

(Rs mn, year ending March 31)

	FY08	FY09E	FY10E	FY11E
Assets				
Total Current Assets	92,689	133,741	179,497	247,017
of which cash and deposits	10,352	24,597	66,435	91,094
Total Current Liabilities & Provisions	41,788	58,024	52,064	87,140
Net Current Assets	**50,901**	**75,717**	**127,433**	**159,877**
Investments	**26,475**	**35,000**	**32,500**	**35,000**
of which Other Marketable	*26,475*	*35,000*	*32,500*	*35,000*
Net Fixed Assets	**36,703**	**42,684**	**44,882**	**47,629**
Intangibles	*3,633*	*3,502*	*3,502*	*3,502*
Goodwill	*11,105*	*11,615*	*11,615*	*11,615*
Capital Work-in-Progress	**8,249**	**7,500**	**7,500**	**7,500**
Other Long Term Assets	**11,701**	**14,219**	**6,975**	**17,264**
Total Assets	**134,030**	**175,120**	**219,290**	**267,270**
of which cash and equivalents	*36,827*	*59,597*	*98,935*	*126,094*
Liabilities				
Borrowings	**7,098**	**6,800**	**6,802**	**6,802**
Other Non Current Liabilities	812	1,000	1,000	800
Minority Interest	2,300	2,749	3,342	4,008
Equity Share Capital	979	979	979	979
Face Value per share (Rs)	*1*	*1*	*1*	*1*
Reserves & Surplus*	122,841	163,592	207,168	254,682
Net Worth	**123,820**	**164,570**	**208,147**	**255,661**
Total Liabilities	**134,030**	**175,120**	**219,290**	**267,270**

*excluding revaluation reserves

Source: Company data, I-Sec Research

Table 7: Quarterly trends

(Rs mn, year ending March 31)

	Dec-07	Mar-08	Jun-08	Sep-08
Net sales	59,241	60,469	64,107	69,534
% growth (YoY)	21.9	17.5	24.3	23.3
EBITDA	15,789	15,126	15,314	18,197
Margin (%)	26.7	25.0	23.9	26.2
Other income	1,048	1,179	332	(1,784)
Extraordinaries Inc / (Loss)	0	0	0	0
Recurring Net Income	13,308	12,558	12,436	12,615

Source: Company data, I-Sec Research

Table 5: Cash Flow Statement

(Rs mn, year ending March 31)

	FY08	FY09E	FY10E	FY11E
Operating Cash flow before W Cap changes	**53,688**	**64,395**	**64,425**	**67,839**
Working Capital Inflow / (Outflow)	(17,221)	(13,144)	(11,050)	(9,619)
Capex	(13,908)	(10,120)	(8,500)	(10,000)
Free Cash flow	**22,559**	**41,132**	**44,875**	**48,220**
Cash Flow from other Invst Act (Ex Capex)	**(13,491)**	**(11,907)**	**13,810**	**(5,546)**
Proceeds from Issue of Share Capital	33	0	0	0
Inc/(Dec) in Borrowings	718	(298)	2	0
Divided paid	(14,953)	(14,681)	(16,848)	(18,016)
Others	**-**	**-**	**-**	**-**
Increase/(Decrease) in Cash	**(5,134)**	**14,245**	**41,839**	**24,659**

Source: Company data, I-Sec Research

Table 6: Key Ratios

(Year ending March 31)

	FY08	FY09E	FY10E	FY11E
Per Share Data (Rs)				
EPS(Basic Recurring)	51.0	58.9	62.9	68.6
Diluted Recurring EPS	51.0	58.9	62.9	68.6
Recurring Cash EPS	54.4	61.6	66.1	75.6
Dividend per share (DPS)	12.8	14.7	15.7	17.2
Book Value per share (BV)	126.5	168.2	212.7	261.2
Growth Ratios (%)				
Operating Income (Sales)	22.7	25.7	5.1	14.4
EBITDA	17.1	24.9	1.2	12.2
Recurring Net Income	22.5	15.4	6.9	9.0
Diluted Recurring EPS	22.5	15.4	6.9	9.0
Diluted Recurring CEPS	16.4	13.1	7.4	14.3
Valuation Ratios (x)				
P/E	10.2	8.9	8.3	7.6
P/CEPS	9.6	8.5	7.9	6.9
P/BV	4.1	3.1	2.5	2.0
EV / EBITDA	8.2	6.2	5.6	4.7
EV / Sales	2.1	1.6	1.4	1.1
EV / FCF	21.5	11.3	9.4	8.2
Operating Ratio				
Software Development Expenses/Sales (%)	53.5	54.3	55.5	56.8
SG&A/Sales (%)	20.5	19.9	19.6	18.8
Other Income / PBT (%)	7.7	(1.3)	5.6	8.6
Effective Tax Rate (%)	13.4	14.4	14.6	19.5
NWC / Total Assets (%)	29.0	32.5	47.0	45.1
Fixed Asset Turnover (x) on average	6.9	7.2	6.9	7.5
Receivables (days) on average	77.4	79.0	82.5	83.0
Payables (days) on average	22.1	21.1	16.7	15.0
D/E Ratio (x) on average	0.1	0.0	0.0	0.0
Return/Profitability Ratio (%)				
Recurring Net Income Margins	21.8	20.0	20.4	19.4
RoIC (Based on Avg)	61.2	56.7	54.8	54.0
RoCE (Based on Avg)	43.9	38.1	31.9	28.1
RoNW (Based on Avg)	46.7	39.9	33.1	29.0
Dividend Payout Ratio	29.3	29.3	29.3	29.3
Dividend Yield	2.5	2.8	3.0	3.3
EBITDA Margins	26.0	25.8	24.9	24.4

Source: Company data, I-Sec Research

Note: Financials estimates excluding CGSL

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