

Tata Consultancy Services

18 September 2012

Reuters: TCS.BO; Bloomberg: TCS IN

Stretched Valuation Drives Downgrade

We attended Tata Consultancy Services' (TCS) quarterly analyst meet. As per the information technology (IT) major, clients are taking decisions on IT budgets and contracts are getting cleared. TCS maintained its earlier commentary of 'front-ended growth' in FY13. The company remains in hiring mode, as 2QFY13 has seen project ramp-ups, which could lead to an onsite shift. This, in turn, could exert pressure on margins. Re-investment - in contracts like Friends Life for example, where upfront costs are incurred - is likely to lead to TCS not achieving full benefits from rupee depreciation. Regards verticals, retail, insurance, manufacturing and hi-tech are witnessing good traction. From a service line perspective, growth is likely to be broad-based, while geographically North America, the UK and continental Europe are registering consistent growth. TCS has not witnessed instances of irrational pricing. We cut our 2QFY13 volume growth estimate to 3.2% QoQ (4.7%) and, in light of the run-up post results, downgrade the stock to Hold (from Buy) with a revised target price of Rs1,415 (Rs1,444) owing to a 2% cut in FY14E EPS.

Status quo on demand, onsite ramp-up seen in 2QFY13: TCS has maintained its earlier stance of 'front-ended growth' for FY13, as clients continue to make IT budget decisions and clear contracts. At this point, despite a volatile global environment, it appears to be 'business as usual' and the deal pipeline has stayed consistent for TCS. The IT major has alluded to some deal ramp-ups in 2QFY13, which is likely to lead to an onsite shift and some pressure on margins during the quarter, given higher costs typically associated with onsite delivery. Hiring remains on track and TCS has no plans to delay the joining dates for campus hires.

Rupee weakness enables re-investment, newer contracts; not to realise full benefits:

A weak rupee, given its benefits to the margin and cash flow profile, has enabled TCS to take newer contracts like Friends Life, which has upfront costs attached to it. The IT major has also re-invested some benefits into its business and has funded investments in new geographies, which operate at lower margins. This is the reason why the company is not likely to fully realise the benefits of a weak rupee at the margin level and its desired target of 27% EBIT margin is unlikely to be significantly surpassed, even though the 27% target is assuming US dollar-rupee rate of Rs48/\$ and the Indian unit is currently at around Rs54/\$.

Vertical, service line comments in line with earlier stance: TCS is seeing good traction in the retail, insurance, manufacturing and hi-tech verticals, even as the view on telecom remains cautious. From a service line perspective, growth is likely to be broad-based, adjusting for the one-off impact of the Friends Life deal on the BPO segment in 1QFY13. This is in line with the IT major's earlier stance also. Geographically, North America, the UK and continental Europe are largely witnessing consistent growth.

No irrational pricing: TCS has not come across instances of irrational pricing, even as the competitive environment remains challenging and concerns emerge about vendors passing on the benefits of a weak rupee in the form of price cuts in order to grab volume share.

Outlook and valuation: We cut our volume growth estimate for 2QFY13 to 3.2% QoQ (4.7%). Given the stock price run-up post results, we downgrade TCS to Hold (from Buy) with a revised TP of Rs1,415 (Rs1,444 earlier) owing to a 2% cut in FY14E EPS.

HOLD
Sector: IT

CMP: Rs1,341

Target Price: Rs1,415

Upside: 5.5%

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Key Data

Current Shares O/S (mn)	1,957.2
Mkt Cap (Rsbn/US\$bn)	2,299.2/42.6
52 Wk H / L (Rs)	1440/963
Daily Vol. (3M NSE Avg.)	1264889.0

One Year Indexed Stock Performance
Price Performance (%)

	1 M	6 M	1 Yr
TCS	(8.1)	1.1	15.0
Nifty Index	4.5	5.5	10.3

Source: Bloomberg

Y/E March (Rsmn)	FY10	FY11	FY12	FY13E	FY14E
Revenue	300,289	373,245	488,938	623,895	731,263
YoY (%)	8.0	24.3	31.0	27.6	17.2
EBITDA	86,800	111,981	144,176	188,987	220,593
EBITDA (%)	28.9	30.0	29.5	30.3	30.2
Adj. PAT	68,895	87,284	106,383	138,958	158,231
YoY (%)	33.2	26.7	21.9	30.6	13.9
FDEPS (Rs)	35.2	44.6	54.4	71.0	80.8
RoE (%)	37.7	37.7	36.7	37.5	33.9
RoCE (%)	35.9	35.9	35.8	35.9	32.4
P/E (x)	38.1	30.0	24.7	18.9	16.6
EV/EBITDA (x)	29.3	22.9	17.7	13.3	11.2

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 1: Earlier estimates, revised estimates

Particulars	Earlier estimates	Revised estimates	Chg (%)
FY13E			
Revenue (US\$m)	11,520	11,450	(0.6)
Revenue (Rsmn)	627,690	623,895	(0.6)
EBITDA (Rsmn)	191,562	188,987	(1.3)
EBITDA margin (%)	30.5	30.3	(23)bps
EPS (Rs)	72.0	71.0	(1.3)
FY14E			
Revenue (US\$m)	13,281	13,176	(0.8)
Revenue (Rsmn)	737,110	731,263	(0.8)
EBITDA (Rsmn)	225,073	220,593	(2.0)
EBITDA margin (%)	30.5	30.2	(37)bps
EPS (Rs)	82.5	80.8	(2.0)

Source: Nirmal Bang Institutional Equities Research

Rating History

Date	Rating	CMP	Target Price (Rs)
2 June 2011	Hold	1,175	1,224
1 July 2011	Hold	1,180	1,224
15 July 2011	Buy	1,124	1,329
12 August 2011	Hold	951	994
23 September 2011	Hold	995	1,019
30 September 2011	Sell	1,060	1,019
9 November 2011	Sell	1,123	1,008
23 November 2011	Hold	1,062	1,114
2 January 2012	Hold	1,161	1,232
18 January 2012	Hold	1,104	1,200
30 March 2012	Hold	1,143	1,200
24 April 2012	Hold	1,059	1,200
4 June 2012	Hold	1,225	1,329
29 June 2012	Hold	1,259	1,329
13 July 2012	Buy	1,236	1,444

Disclaimer

Stock Ratings Absolute Returns

BUY > 15%

HOLD 0-15%

SELL < 0%

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