

## Company Flash

16 January 2008 | 8 pages

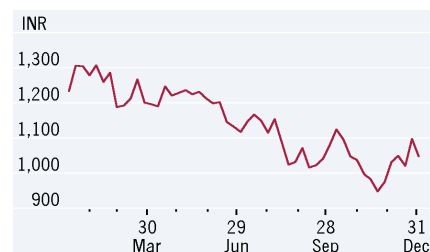
# Tata Consultancy Services (TCS.BO)

## Buy: Mixed Results – US Growth Slows

- 3QFY08 broadly in line** — Revenues of \$1.5b (+6.2% qoq) were below our expectation of \$1.53b, net profit at Rs.13.3b was higher than our expectation of Rs.13b. EBIT margins were up 33bp qoq. Revenue growth comprises ~5.3% volume growth and ~0.5% pricing increase qoq.
- Sluggish North America revenues a concern** — North American revenues increased ~1% qoq (international revenue growth was ~5% qoq). With a challenging macro-environment, this remains the key investor concern.
- BFSI revenues increase ~7% qoq** — BFSI revenues increased ~7% qoq – higher than the company average. In both Infosys and TCS – BFSI revenues have grown better than the company average.
- Gross hiring of ~8000; FY08 target maintained** — TCS hired ~8,000 employees in the quarter (lower than the indicated number of 9,000). However, management maintained its earlier guidance for full-year hiring (~32,500).
- Cautiously confident on outlook** — Management indicated that budget discussions with clients did not indicate any weakness in demand. TCS was pursuing ~25 large deals. However, given the negative macro news, it continues to monitor the outlook and has a cautiously positive view on demand.
- Challenging macro; prefer Tier 1s** — Investor concerns continue to be on the slowing US economy and the impact on demand for IT Services. We continue to believe that Tier 1s are better placed. With US revenues less than half of the total, TCS is relatively better placed – the stock trades at ~15x FY09E.

|                              |                           |
|------------------------------|---------------------------|
| <b>Buy/Low Risk</b>          | <b>1L</b>                 |
| Price (16 Jan 08)            | Rs944.50                  |
| Target price                 | Rs1,290.00                |
| Expected share price return  | 36.6%                     |
| Expected dividend yield      | 1.5%                      |
| <b>Expected total return</b> | <b>38.1%</b>              |
| Market Cap                   | Rs924,298M<br>US\$23,546M |

### Price Performance (RIC: TCS.BO, BB: TCS IN)



### Statistical Abstract

| Year to | Net Profit | Diluted EPS | EPS growth | P/E  | P/B  | ROE  | Yield |
|---------|------------|-------------|------------|------|------|------|-------|
| 31 Mar  | (RsM)      | (Rs)        | (%)        | (x)  | (x)  | (%)  | (%)   |
| 2006A   | 29,074     | 29.71       | 39.1       | 31.8 | 15.8 | 64.3 | 0.7   |
| 2007A   | 40,608     | 41.50       | 39.7       | 22.8 | 10.4 | 55.1 | 1.2   |
| 2008E   | 51,602     | 52.73       | 27.1       | 17.9 | 7.3  | 47.8 | 1.5   |
| 2009E   | 60,085     | 61.40       | 16.4       | 15.4 | 5.4  | 40.3 | 1.7   |
| 2010E   | 66,003     | 67.45       | 9.8        | 14.0 | 4.2  | 33.8 | 1.9   |

Source: Powered by dataCentral

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### Other Key Highlights

- Gross margins increased ~50bp qoq due to better pricing and productivity improvement despite higher onsite component of revenues and rupee appreciation.
- Reported gross hiring was ~7,500 employees. This was net of 439 employees in a division, which TCS divested in the quarter. Adding this, gross employee addition for the quarter was ~8,000 employees.
- Company announced seven US\$50m+ deals including US\$1.2b deal from the Nielsen company.
- Attrition inched up marginally to 12.2% for LTM; IT services attrition was at 11.5% while BPO services was 20%.
- Company announced issuance of non-convertible redeemable preferential stock of Rs. 1bn to promoters (Tata Sons). Management indicated that this was done to meet some fiscal requirement.
- Company had net forex gains of Rs.660m (reported in other income) during the quarter. Cash flow hedge gains (recognized in revenues) were Rs.450m for the quarter – which is flattish qoq.
- Total forex hedges at the end of quarter were US\$3.1b.
- Revenue growth of 5% in INR terms was net impact of 5.3% volume growth, 0.5% pricing improvement 0.8% due to onsite shift and negative impact of 1.6% from stronger INR.
- For the first time, North American revenue share was below 50% - TCS is clearly the most diversified Tier I IT services company.

Figure 1. Key Financials, Rs m

| Rs mn                         | 3Q07   | 2Q08   | 3Q08   | QoQ    | YoY    |
|-------------------------------|--------|--------|--------|--------|--------|
| Revenue (US\$ m)              | 1,098  | 1,416  | 1,503  | 6.2%   | 36.8%  |
| Revenue                       | 48,605 | 56,398 | 59,241 | 5.0%   | 21.9%  |
| Cost of revenue               | 26,506 | 31,106 | 32,362 | 4.0%   | 22.1%  |
| Gross profit                  | 22,099 | 25,293 | 26,878 | 6.3%   | 21.6%  |
| Gross margin                  | 45.5%  | 44.8%  | 45.4%  | 52bp   | -10bp  |
| Operating expenses            | 9,427  | 11,854 | 12,565 | 6.0%   | 33.3%  |
| EBIT                          | 12,673 | 13,439 | 14,313 | 6.5%   | 12.9%  |
| EBIT margin                   | 26.1%  | 23.8%  | 24.2%  | 33bp   | -191bp |
| Depreciation and amortization | 1,080  | 1,381  | 1,475  | 6.8%   | 36.6%  |
| EBITDA                        | 13,752 | 14,821 | 15,788 | 6.5%   | 14.8%  |
| EBITDA margin                 | 28.3%  | 26.3%  | 26.7%  | 37bp   | -164bp |
| Other income                  | 300    | 528    | 1,048  | 98.6%  | 249.5% |
| Profit before tax             | 12,972 | 14,544 | 15,361 | 5.6%   | 18.4%  |
| Income tax expense            | -1,828 | -2,037 | -1,947 | -4.4%  | 6.5%   |
| Income from operations        | 11,144 | 12,507 | 13,414 | 7.3%   | 20.4%  |
| Affiliates/Minority           | -98    | -38    | -107   | 182.1% | 9.4%   |
| Net profit                    | 11,047 | 12,469 | 13,308 | 6.7%   | 20.5%  |
| EPS - basic & diluted         | 11.29  | 12.74  | 13.60  | 6.7%   | 20.4%  |

Source: Company Reports

**Figure 2. Key HR and Execution Metrics**

|                             | 1Q07   | 2Q07   | 3Q07   | 4Q07   | 1Q08   | 2Q08    | 3Q08    |
|-----------------------------|--------|--------|--------|--------|--------|---------|---------|
| TCS (Consolidated)          | 71,190 | 78,028 | 83,500 | 89,419 | 94,902 | 104,347 | 108,229 |
| TCS Ltd.                    | 67,530 | 74,193 | 79,755 | 85,582 | 91,094 | 100,362 | 104,399 |
| Indian subsidiaries (Total) | 3,660  | 3,835  | 3,745  | 3,837  | 3,808  | 3,985   | 3,830   |
| Gross addition (Total)      | 7,095  | 8,919  | 7,835  | 8,613  | 8,706  | 12,523  | 7,522   |
| Net addition (Total)        | 4,698  | 6,663  | 5,562  | 5,827  | 5,512  | 9,268   | 4,037   |
| Trainees                    | 2,574  | 3,764  | 2,478  | 3,843  | 2,898  | 5,899   | 3,378   |
| Experienced                 | 2,703  | 4,200  | 4,015  | 2,918  | 4,795  | 5,658   | 3,661   |
| <b>Execution matrices</b>   |        |        |        |        |        |         |         |
| Attrition rate (%)          | 10.6%  | 10.6%  | 10.8%  | 11.3%  | 11.5%  | 11.5%   | 12.2%   |
| <b>Utilization rate</b>     |        |        |        |        |        |         |         |
| Including trainees          | 77.3%  | 75.2%  | 75.0%  | 74.7%  | 76.0%  | 73.7%   | 72.6%   |
| Excluding trainees          | 80.1%  | 79.4%  | 78.2%  | 79.6%  | 79.1%  | 78.9%   | 77.7%   |

Source: Company Reports

**Figure 3. Revenue Mix**

|                            | 1Q07  | 2Q07  | 3Q07  | 4Q07  | 1Q08  | 2Q08  | 3Q08  |
|----------------------------|-------|-------|-------|-------|-------|-------|-------|
| <b>Geographic Mix</b>      |       |       |       |       |       |       |       |
| Americas                   | 56.1% | 57.0% | 56.5% | 55.3% | 55.1% | 56.4% | 54.2% |
| Europe                     | 27.7% | 28.5% | 28.6% | 29.0% | 29.3% | 28.3% | 29.2% |
| India                      | 10.6% | 8.4%  | 7.9%  | 9.4%  | 9.0%  | 8.2%  | 9.4%  |
| Others                     | 5.6%  | 6.1%  | 7.0%  | 6.3%  | 6.6%  | 7.1%  | 7.2%  |
| <b>Service Mix</b>         |       |       |       |       |       |       |       |
| ADM & engineering services | 66.9% | 67.8% | 68.4% | 66.5% | 66.4% | 63.6% | 62.6% |
| Enterprise solutions & PI  | 23.0% | 21.5% | 20.7% | 21.8% | 21.1% | 23.0% | 23.6% |
| Asset leverages solutions  | 2.6%  | 2.5%  | 2.8%  | 3.1%  | 3.3%  | 3.4%  | 3.3%  |
| Others                     | 7.5%  | 8.2%  | 8.1%  | 8.6%  | 9.2%  | 10.0% | 10.5% |
| <b>Vertical Mix</b>        |       |       |       |       |       |       |       |
| BFSI                       | 41.2% | 42.7% | 43.5% | 41.3% | 43.1% | 43.3% | 44.0% |
| Manufacturing              | 16.0% | 15.3% | 15.2% | 15.1% | 12.4% | 12.7% | 12.5% |
| Telecommunications         | 16.5% | 16.6% | 16.8% | 17.6% | 17.1% | 17.8% | 17.5% |
| Life sciences & healthcare | 4.1%  | 4.0%  | 4.5%  | 4.7%  | 6.1%  | 5.6%  | 5.3%  |
| Retail & distribution      | 6.7%  | 6.6%  | 6.9%  | 7.9%  | 8.0%  | 7.6%  | 7.2%  |
| Transportation             | 3.6%  | 3.4%  | 2.9%  | 3.2%  | 2.8%  | 4.4%  | 4.7%  |
| Energy & utilities         | 2.6%  | 2.7%  | 2.2%  | 2.3%  | 2.4%  | 2.5%  | 3.1%  |
| Others                     | 9.3%  | 8.7%  | 8.0%  | 7.9%  | 8.1%  | 6.1%  | 5.7%  |

Source: Company Reports

**Figure 4. Key Client Metrics**

|                             | 1Q07  | 2Q07  | 3Q07  | 4Q07  | 1Q08  | 2Q08  | 3Q08  |
|-----------------------------|-------|-------|-------|-------|-------|-------|-------|
| Total active clients        | 764   | 742   | 754   | 780   | 771   | 814   | 857   |
| New clients                 | 62    | 58    | 55    | 43    | 54    | 51    | 54    |
| <b>Client relationships</b> |       |       |       |       |       |       |       |
| >\$1 million                | 258   | 274   | 288   | 297   | 322   | 334   | 347   |
| >\$5 million                | 97    | 105   | 114   | 119   | 126   | 139   | 138   |
| >\$10 million               | 65    | 70    | 74    | 75    | 85    | 92    | 97    |
| >\$20 million               | 33    | 32    | 37    | 39    | 45    | 51    | 53    |
| >\$50 million               | 10    | 15    | 15    | 14    | 18    | 18    | 19    |
| <b>Client concentration</b> |       |       |       |       |       |       |       |
| Top client                  | 4.0%  | 4.9%  | 5.7%  | 6.6%  | 6.8%  | 7.0%  | 6.9%  |
| Top 5 clients               | 16.7% | 16.8% | 17.4% | 18.5% | 19.0% | 19.1% | 19.1% |
| Top 10 clients              | 26.8% | 26.8% | 27.5% | 28.4% | 29.3% | 27.6% | 29.7% |

Source: Company Reports

# Tata Consultancy Services

## Company description

TCS is India's largest and among the oldest IT companies. It is part of the diversified Tata Group, one of the largest corporate groups in Asia. It has more than 100,000 employees, including its subsidiaries, with marketing presence across 32 countries and development presence in 10 countries besides India. It provides a comprehensive range of IT services to industries such as banking and financial services, insurance, manufacturing, telecommunications, retail and transportation. It had more than 800 active clients, including six of the Fortune Top 10 companies in the US. The company started with data processing work in 1968, and was the first to provide offshore services in 1974. Over the last three decades, the company has come a long way with deep technical and project management expertise in handling complex client projects and strong offshore processes.

## Investment strategy

We rate TCS as Buy/Low Risk (1L) based on a fundamental 12-month view. As India's largest and most experienced IT services firm, TCS looks well positioned to benefit from the growing demand for offshore IT services. It is a well-regarded stock among investors familiar with India and the IT-services sector. We believe TCS' margins in its international IT services business (around 95% of EBIT) are likely to trend down over the next few years. However, we expect this decline to be relatively modest, as we expect positive leverage from a better onsite-offshore mix, more hiring of fresh graduates, and improved utilization with a strong demand outlook to offset margin pressures from wage inflation. We expect revenue CAGR of 21.8% and an EPS CAGR of 16.9% in FY07-10E.

## Valuation

Our target price of Rs1,290 is based on 21x FY09E EPS, derived from a small discount to our target 23x FY09E EPS for Infosys, TCS's closest peer on business model. We expect TCS to continue to trade at slightly lower multiples than Infosys due to investors' greater comfort and familiarity with Infosys and the periodic supply of additional stock by Tata Sons. Our target price assumes a one-year forward P/E of 15-20% above the average BSE Sensex multiple, which we think is justified given TCS' superior FCF, RoIC and growth rates than the overall market, and it actually implies a slightly lower premium than that for Infosys. We believe P/E remains the most appropriate valuation measure given TCS' profitable track record and strong earnings visibility.

## Risks

We rate TCS as Low Risk, consistent with our quantitative stock-volatility based risk-rating system. Fundamentally also, given the stock's below-market beta, its relatively high earnings visibility, strong cash flows and balance sheet - along with our Low Risk rating for its local peers Infosys and Wipro - we believe a Low Risk rating for TCS is reasonable. The key downside risks that could impede the stock from reaching our target price include: (1) any significant appreciation of the rupee against the US Dollar/Euro/GBP; (2) a sharp

slowdown in the US economy; (3) H1B visa quotas; (4) large exposure to fixed-price contracts; (5) higher onsite revenue contribution (~53% of total); and (6) acquisition-related risks, including M&A with other Tata-group IT firms.

# Appendix A-1

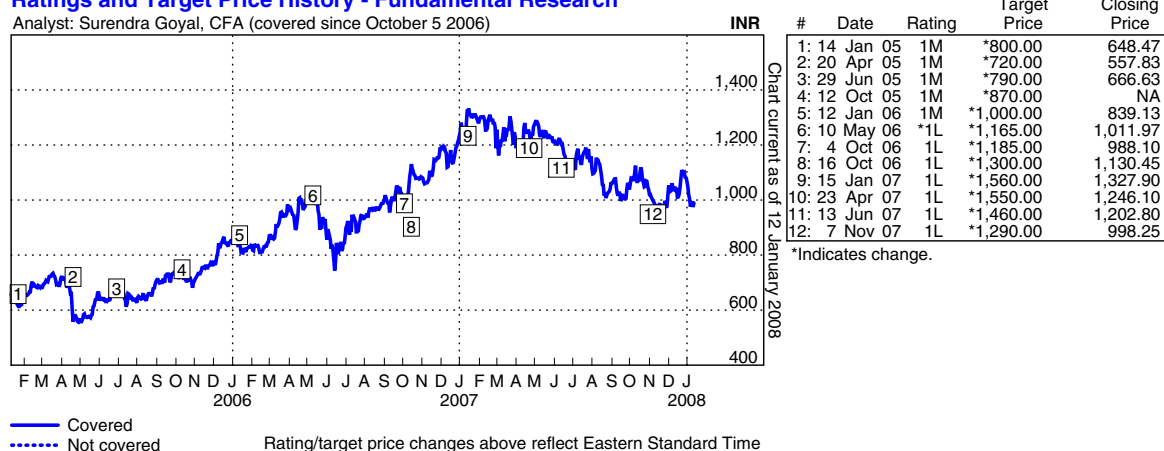
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