Tata Consultancy Services

Volume growth to remain strong

Our recent interaction with TCS reaffirms our belief that volume recovery is on track for Indian IT service players. The management indicated that the demand environment has improved materially over the last two quarters. Though discretionary spending is still largely curtailed, the deal pipeline is back to pre-crisis levels due to client-led cost-cutting and business transformation initiatives. Hiring too has picked up in Q3FY10. Though room for further margin improvement is limited, the goal would be to sustain margins in a narrow range. Post our meeting, we are increasing our FY11 revenue and earnings estimates for TCS by 3.2% and 5.3% respectively. Consequently, our target price increases to Rs 750 from Rs 694 earlier. Maintain Buy.

Volume growth to remain strong despite seasonality

Consistent volume growth over the last two quarters has been the distinguishing feature for TCS as compared to Infosys and Wipro in the recent recovery. In Q2FY10, volumes for TCS grew 5% QoQ as compared to 1.4% and -1.5% for Infosys and Wipro (Global IT) respectively. For Q3FY10, volume growth is expected to be slower due to the seasonal pattern which sees fewer working days in the quarter. We expect volumes to increase by 3.5% QoQ – ahead of that projected for Infosys. The quarter would continue to get a boost from the resurgent BFSI vertical along with the stabilisation in retail and telecom.

BFSI will continue to lead the way

Integration and compliance-related IT spending in the BFSI vertical remains strong, lending a crucial fillip to the volume recovery. Revenue contribution from BFSI is expected to increase further from 45% in Q2FY10, as top clients in the vertical maintain strong growth momentum. Besides BFSI, the retail vertical too is witnessing strong growth due to transformational initiatives by clients. Revenue contribution from the retail segment has increased from ~9% in Q1FY09 to ~12% in Q2FY10. Volumes in verticals like manufacturing and telecom have stabilised in Q2FY10; however recovery in these segments is highly dependent on improvement in consumer spending in the US and Europe.

Deal pipeline back to pre-crisis levels

The management indicated that the discretionary IT spend continues to be under pressure as clients are still to witness a consistent revenue recovery. However, the deal pipeline has recovered materially in the last two quarters and is back to pre-Lehman levels. The deal closure rate too has improved but the sales cycle remains elongated. The project pipeline is benefiting from pent-up demand accumulated over the longer-than- average recession and continued cost-cutting initiatives by clients.

What's New?	Target	Rating	Estimates

CMP	TARGET	RATING	RISK
Rs 690	Rs 750	BUY	MEDIUM

BSE	NSE	BLOOMBERG
532540	TCS	TCS IN

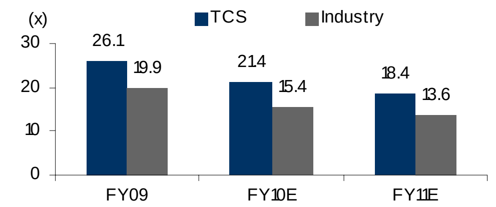
Company data

Market cap (Rs mn / US$ mn)	1,347,351 / 29,119
Outstanding equity shares (mn)	1,957
Free float (%)	492.9
Dividend yield (%)	1.0
52-week high/low (Rs)	712 / 220
2-month average daily volume	2,897,792

Stock performance

Returns (%)	CMP	1-mth	3-mth	6-mth
TCS	690	9.1	30.1	96.6
BSE IT	4,776	7.9	14.0	53.3
Sensex	17,190	8.1	10.5	15.8

P/E comparison



Valuation matrix

(x)	FY08	FY09	FY10E	FY11E
P/E @ CMP	26.9	26.1	21.4	18.4
P/E @ Target	29.3	28.4	23.3	20.0
EV/EBITDA @ CMP	22.3	18.5	16.1	14.6

Financial highlights

(Rs mn)	FY08	FY09	FY10E	FY11E
Revenue	228,614	278,129	298,274	332,115
Growth (%)	*22.7*	*21.7*	*7.2*	*11.3*
Adj net income	50,182	51,723	63,067	73,304
Growth (%)	*23.2*	*3.1*	*21.9*	*16.2*
FDEPS (Rs)	25.6	26.4	32.2	37.5
Growth (%)	*23.2*	*3.1*	*21.9*	*16.2*

Profitability and return ratios

(%)	FY08	FY09	FY10E	FY11E
EBITDA margin	26.0	25.8	27.6	27.4
EBIT margin	23.5	23.7	25.1	24.9
Adj PAT margin	22.0	18.6	21.1	22.1
ROE	47.0	36.9	35.4	32.4
ROIC	52.6	46.1	43.2	45.0
ROCE	44.6	35.4	34.1	31.5

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"Honourable Mention" in Institutional Investor 2009
RHH Research is also available on Bloomberg FTIS <GO> and Thomson First Call

IT budgets for 2010 expected to be finalised on time in the Jan-Mar quarter

Positive feelers on 2010 IT budgets

As compared to 2009, the IT budgeting exercise for 2010 is expected to be concluded on time in the January to March quarter and with higher visibility on actual spending. Though IT budgets are expected to show flat to marginal growth, Indian players would benefit from increased allocation to offshore expenditure. The management indicated that it is witnessing a shift in client focus from in-house/onsite outsourcing to offshoring in order to increase cost flexibility and bolster return on investments. However, a double-dip recession remains the largest concern for 2010 IT budgets.

Hiring steps up minus salary hikes

TCS plans to add 8,000 fresh graduates in Q3FY10 and 10,000 in Q4FY10. The company has also accelerated its lateral recruitment process in order to cater to the improving demand environment. For FY11, TCS would be visiting campuses in Q4FY10. We expect the company to make about 25,000 campus offers. Despite the step-up in hiring, the management does not expect salary hikes before Q2FY11. This contrasts with the 2% and 8% onsite and offshore salary hikes given by Infosys in Q3FY10. However, TCS would continue to maintain a reasonable variable pay component every quarter.

Margin pressure due to currency and wage increases to be offset by productivity gains and higher utilisation

Focused on sustaining margins at current level

In Q2FY10, TCS' EBITDA margin swelled 253bps YoY to 28.7%. Margin expansion arose from employee cost control and increased offshore leverage. Offshore revenues as a percentage of the total have increased by 830bps over the last four quarters to 51%. Though room for further margin expansion is limited considering the stronger rupee, increased hiring and expected wage inflation, the management now aims to maintain margins at the current level.

The most important margin lever available is utilisation rates which are still low. Including trainees, TCS recorded a utilisation rate of 73.6% in Q2FY10, lower than its historical range of ~75–77%. Also, further scope to increase the share of fixed price projects will provide support to the operating margin as productivity improves. And, in order to protect itself against rupee volatility, TCS has increased its forex hedges for Q3FY10 from US$ 75mn (at Rs 41/US$) to US$ 210mn now, with incremental hedges at Rs 46–47/US$. The company however has not increased its cash flow hedges for future quarters.

Target price increased to Rs 750 – Buy

Consequent to our management meet, we are raising our volume growth expectations for FY11 from 15% earlier to 17%. Our EBITDA margin estimate for the fiscal has also been increased by 39bps to 27.4%. In all, we have raised our FY11 revenue and earnings projections by 3.2% and 5.3% respectively, while FY10 numbers remain largely unchanged. Our forecast is based on an exchange rate assumption of Rs 46/US$ and Rs 44/US$ by March '10 and March '11 respectively.

Earnings estimates for FY11 revised upwards by 5.3%

Fig 1 - Revised estimates

Key parameters (Rs mn)	FY10E			FY11E		
	Old	New	% Chg	Old	New	% Chg
Revenue	297,627	298,274	0.2	321,953	332,115	3.2
EBITDA	82,222	82,401	0.2	86,809	90,851	4.7
EBITDA margin (%)	27.6	27.6	0 bps	27.0	27.4	39 bps
FDEPS (Rs)	32.1	32.2	0.2	35.6	37.5	5.3

Source: RHH

Consequent to the FY11 earnings revision, we are increasing our target price from Rs 694 to Rs 750. At our target price the stock would trade at 20x FY11E earnings. We maintain our positive outlook on the stock with a Buy rating.

Consolidated financials

Profit and Loss statement

Y/E March (Rs mn)	FY08	FY09	FY10E	FY11E
Revenues	**228,614**	**278,129**	**298,274**	**332,115**
Growth (%)	*22.7*	*21.7*	*7.2*	*11.3*
EBITDA	**59,397**	**71,781**	**82,401**	**90,851**
Growth (%)	*17.3*	*20.9*	*14.8*	*10.3*
Depreciation & amortisation	5,746	5,766	7,419	8,141
EBIT	53,651	66,015	74,982	82,711
Growth (%)	*15.5*	*23.0*	*13.6*	*10.3*
Interest	452	523	341	369
Other income	4,902	(4,149)	778	6,007
EBT	58,101	61,343	75,420	88,348
Income taxes	7,494	9,012	11,446	14,264
Effective tax rate (%)	*12.9*	*14.7*	*15.2*	*16.1*
Extraordinary items	-	-	-	-
Min into / inc from associates	432	600	923	820
Reported net income	50,191	51,723	63,067	73,304
Adjustments	9	-	-	-
Adjusted net income	**50,182**	**51,723**	**63,067**	**73,304**
Growth (%)	*23.2*	*3.1*	*21.9*	*16.2*
Shares outstanding (mn)	1,957.2	1,957.2	1,957.2	1,957.2
FDEPS (Rs) (adj)	**25.6**	**26.4**	**32.2**	**37.5**
Growth (%)	*23.2*	*3.1*	*21.9*	*16.2*
DPS (Rs)	7.0	7.0	8.0	9.0

Balance sheet

Y/E March (Rs mn)	FY08	FY09	FY10E	FY11E
Cash and cash eq	10,352	13,440	38,162	77,586
Accounts receivable	53,899	60,463	61,974	63,214
Inventories	424	366	421	463
Other current assets	27,102	35,351	41,770	45,947
Investments	26,503	17,281	29,781	39,781
Gross fixed assets	33,205	49,583	58,833	70,333
Net fixed assets	21,159	31,163	33,614	37,574
CWIP	9,055	6,332	4,332	5,082
Intangible assets	14,738	34,146	33,525	32,925
Deferred tax assets, net	3,552	4,262	4,901	5,391
Other assets	9,035	23,911	27,498	30,247
Total assets	**175,818**	**226,714**	**275,979**	**338,211**
Accounts payable	9,712	10,116	10,762	12,678
Other current liabilities	28,575	42,099	46,308	50,939
Provisions	3,500	4,200	4,830	5,313
Debt funds	7,098	7,913	7,077	7,677
Other liabilities	3,112	5,842	7,168	8,284
Equity capital	979	979	979	979
Reserves & surplus	122,841	155,567	198,854	252,341
Shareholder's funds	123,820	156,545	199,833	253,320
Total liabilities	**175,818**	**226,714**	**275,979**	**338,211**
BVPS (Rs)	63.8	80.5	102.6	129.9

Cash flow statement

Y/E March (Rs mn)	FY08	FY09	FY10E	FY11E
Net income + Depreciation	55,937	57,513	71,106	82,045
Non-cash adjustments	(2,526)	(2,889)	(1,411)	2,033
Changes in working capital	(12,119)	(3,209)	(6,773)	(3,186)
Cash flow from operations	41,292	51,415	62,922	80,891
Capital expenditure	(10,941)	(10,623)	(7,250)	(12,250)
Change in investments	(13,792)	10,396	(12,500)	(10,000)
Other investing cash flow	(2,666)	(36,759)	-	-
Cash flow from investing	(27,399)	(36,985)	(19,750)	(22,250)
Issue of equity	-	-	-	-
Issue/repay debt	631	(378)	(836)	600
Dividends paid	(14,832)	(16,085)	(17,615)	(19,817)
Other financing cash flow	-	-	-	-
Change in cash & cash eq	(309)	(2,033)	24,721	39,424
Closing cash & cash eq	10,352	13,440	38,162	77,586

Economic Value Added (EVA) analysis

Y/E March	FY08	FY09	FY10E	FY11E
WACC (%)	13.9	15.2	14.2	14.2
ROIC (%)	52.6	46.1	43.2	45.0
Invested capital (Rs mn)	100,704	143,793	150,979	157,240
EVA (Rs mn)	38,976	44,398	43,642	48,362
EVA spread (%)	38.7	30.9	28.9	30.8

Financial ratios

Y/E March	FY08	FY09	FY10E	FY11E
Profitability & Return ratios (%)				
EBITDA margin	26.0	25.8	27.6	27.4
EBIT margin	23.5	23.7	25.1	24.9
Net profit margin	22.0	18.6	21.1	22.1
ROE	47.0	36.9	35.4	32.4
ROCE	44.6	35.4	34.1	31.5
Working Capital & Liquidity ratios				
Receivables (days)	94	94	95	89
Inventory (days)	1	1	1	1
Payables (days)	24	24	24	24
Current ratio (x)	2.4	2.1	2.5	2.9
Quick ratio (x)	1.7	1.4	1.8	2.2
Turnover & Leverage ratios (x)				
Gross asset turnover	7.8	6.7	5.5	5.1
Total asset turnover	1.5	1.4	1.2	1.1
Interest coverage ratio	118.8	126.1	219.8	224.2
Adjusted debt/equity	0.1	0.1	0.0	0.0
Valuation ratios (x)				
EV/Sales	5.8	4.8	4.4	4.0
EV/EBITDA	22.3	18.4	16.1	14.6
P/E	26.8	26.0	21.4	18.4
P/BV	10.8	8.5	6.7	5.3

Quarterly trend

Particulars	Q2FY09	Q3FY09	Q4FY09	Q1FY10	Q2FY10
Revenue (Rs mn)	69,534	72,770	71,718	72,070	74,351
YoY growth (%)	*25.3*	*24.0*	*18.6*	*12.4*	*6.9*
QoQ growth (%)	*8.5*	*4.7*	*(1.4)*	*0.5*	*3.2*
EBITDA (Rs mn)	16,848	18,020	17,000	17,892	19,531
EBITDA margin (%)	*24.2*	*24.8*	*23.7*	*24.8*	*26.3*
Adj net income (Rs mn)	12,777	13,693	13,330	15,431	16,478
YoY growth (%)	*2.2*	*1.0*	*6.2*	*23.1*	*29.0*
QoQ growth (%)	*2.0*	*7.2*	*(2.6)*	*15.8*	*6.8*

DuPont analysis

(%)	FY07	FY08	FY09	FY10E	FY11E
Tax burden (Net income/PBT)	84.2	86.4	84.3	83.6	83.0
Interest burden (PBT/EBIT)	104.2	108.3	92.9	100.6	106.8
EBIT margin (EBIT/Revenues)	24.9	23.5	23.7	25.1	24.9
Asset turnover (Revenues/Avg TA)	172.7	149.3	138.2	118.7	108.1
Leverage (Avg TA/Avg equtiy)	145.8	143.4	143.6	141.1	135.5
Return on equity	**55.0**	**47.0**	**36.9**	**35.4**	**32.4**

Company profile

TCS is India's largest and oldest IT services provider with revenues and earnings of US$ 6bn and US$ 1.1bn respectively in FY09. The company has built strong business competencies driven by a three-pronged strategy: a) a Global Network Delivery Model (GNDM) – offshore and nearshore presence, b) end-to-end services, c) strategic acquisitions to expand service offerings and market reach.

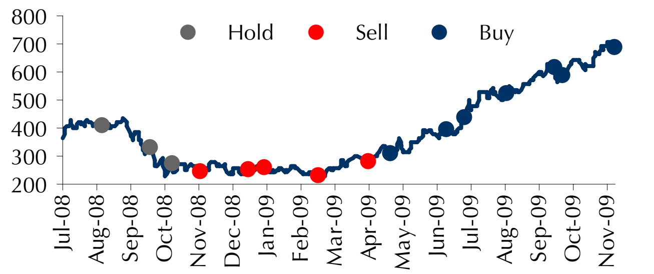
Shareholding pattern

(%)	Dec-08	Mar-09	Jun-09
Promoters	76.2	76.2	75.1
FIIs	10.5	10.0	11.2
Banks & FIs	7.2	7.9	7.5
Public	6.1	5.9	6.2

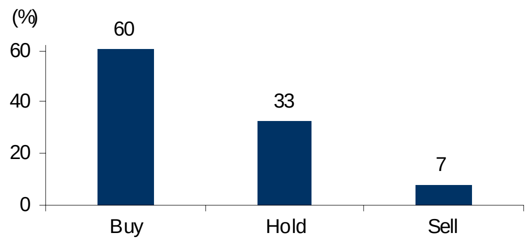
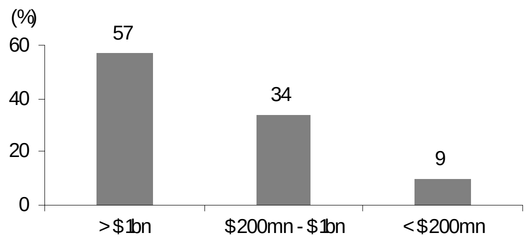
Recommendation history

Date	Event	Reco price	Tgt price	Reco
21-Aug-08	RHH Compendium	409	481	Hold
6-Oct-08	Quarterly Preview	329	392	Hold
24-Oct-08	Results Review	274	318	Hold
21-Nov-08	Sector Report	241	298	Sell
2-Jan-09	Quarterly Preview	249	273	Sell
16-Jan-09	Results Review	255	273	Sell
6-Mar-09	Sector Report	233	226	Sell
21-Apr-09	Results Review	281	240	Sell
12-May-09	Sector Update	308	342	Buy
2-Jul-09	Quarterly Preview	388	423	Buy
17-Jul-09	Results Review	434	466	Buy
25-Aug-09	Sector Update	521	531	Buy
6-Oct-09	Quarterly Preview	614	630	Buy
16-Oct-09	Results Review	598	694	Buy
13-Nov-09	Sector Update	623	694	Buy
2-Dec-09	Company Update	690	750	Buy

Stock performance



Coverage Profile

By recommendation	By market cap (US$)
	

Recommendation interpretation

Recommendation	Expected absolute returns (%) over 12 months
Buy	More than 15%
Hold	Between 15% and –5%
Sell	Less than –5%

Recommendation structure changed with effect from March 1, 2009

Expected absolute returns are based on share price at market close unless otherwise stated. Stock recommendations are based on absolute upside (downside) and have a 12-month horizon. Our target price represents the fair value of the stock based upon the analyst's discretion. We note that future price fluctuations could lead to a temporary mismatch between upside/downside for a stock and our recommendation.

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