Flashnote

HSBC Global Research

Telecoms, Media & Technology
IT Services
Equity – India

Tata Consultancy Services (TCS)

Upgrading to OW(V): Still a solid defensive investment

- **Stability in BFSI and Telecom to offset weakness in Manufacturing and Hi-tech in the near term**
- **TCS has a defensive revenue profile, margin leverage, and the prospect of a lowered valuation gap to peers**
- **We are raising our target price to INR640 from INR480 and upgrading our rating to Overweight (V) from Neutral (V)**

Overweight (V)

Target price (INR)	**640.00**
Share price (INR)	**527.00**
Potential total return (%)	**21.4**

Performance	1M	3M	12M
Absolute (%)	0.2	51.1	29.3
Relative^ (%)	0.2	43.1	19.7

Index^	BOMBAY SE IDX
RIC	TCS.BO
Bloomberg	TCS IN
Market cap (USDm)	21,033
Market cap (INRm)	1,031,455
Enterprise value (INRm)	967,183
Free float (%)	15

Note: (V) = volatile (please see disclosure appendix)

We remain bullish on the IT sector (see portfolio strategy in *India Quarterly: Pricing in a recovery?* 20 July 2009), but we are selective in the top-tier IT sector for absolute and intra-sector performance. We prefer companies with the right blend of structural growth services, sector-specific exposure, and cyclical services portfolio.

TCS has defensive revenue profile: Although we highlighted TCS's defensive revenue profile (65-70% from BFSI, Retail, utilities, and India) in our 20 July note, *Solid defensive investment*, we base our outperform thesis on TCS on stabilising telecom exposure, potential margin leverage, further vendor consolidation benefits, continued offshore transition, and reducing the valuation discount to peers.

BFSI + Telecom (57% of revenues): Our channel checks suggest increasing stability in the BFSI market and a pickup in discretionary spending, albeit patchily so far. We expect the telecom market to be flat in the near term, balanced by cross-currents such as a muted telecom services providers (TSP) spending outlook but increased efficiency-driven offshoring by telecom equipment manufacturers (TEMs) and increased traction in emerging markets.

Valuation: Historically, TCS's valuation gap to Infosys has declined in an improving macro environment and better operational performance by TCS. We expect TCS profit relative to Infosys's to improve and the valuation gap to be bridged further. We value the company at 19x on our FY11 EPS of INR34, a modest 5% discount to Infosys. We are raising our relative valuation-based target price to INR640 from INR480 and upgrading our rating to Overweight (V) from Neutral (V).

Risks: Demand environment deteriorates further, further price decline, higher hedging losses.

Tata Consultancy Services: Key data

YE March	Sales (INRm)	EBIT (%)	EPS (INR)	EPS y/y	PE
FY09a	278,130	23.8%	26.9	4.6%	19.6x
FY10e	294,422	24.0%	30.5	13.5%	17.3x
FY11e	327,848	24.1%	33.9	11.1%	15.6x

Source: HSBC estimates

1 September 2009

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Financials & valuation

Financial statements

Year to	03/2009a	03/2010e	03/2011e	03/2012e
Profit & loss summary (INRm)				
Revenue	278,130	294,422	327,848	364,487
EBITDA	71,699	77,060	85,568	94,767
Depreciation & amortisation	-5,641	-6,320	-6,557	-7,290
Operating profit/EBIT	66,058	70,740	79,011	87,477
Net interest	3,257	4,375	3,856	5,750
PBT	61,506	72,674	81,647	92,617
HSBC PBT	61,506	72,674	81,647	92,617
Taxation	-8,390	-12,394	-14,696	-20,376
Net profit	52,569	59,595	66,266	71,557
HSBC net profit	52,569	59,595	66,266	71,557
Cash flow summary (INRm)				
Cash flow from operations	53,902	56,605	65,934	75,096
Capex	-11,088	-11,777	-13,114	-14,579
Cash flow from investment	-24,038	-22,623	-13,114	-14,579
Dividends	-16,061	-18,319	-20,933	-22,605
Change in net debt	-3,748	-26,779	-31,565	-37,590
FCF equity	47,529	50,536	52,456	55,524
Balance sheet summary (INRm)				
Intangible fixed assets	33,889	33,713	33,713	33,713
Tangible fixed assets	41,896	46,669	53,226	60,516
Current assets	151,380	184,623	225,345	272,974
Cash & others	43,126	69,639	101,204	138,795
Total assets	227,166	265,004	312,284	367,202
Operating liabilities	44,496	41,589	42,852	48,134
Gross debt	5,632	5,367	5,367	5,367
Net debt	-37,493	-64,273	-95,838	-133,428
Shareholders funds	157,000	198,612	243,945	292,897
Invested capital	139,544	153,776	168,228	180,274

Ratio, growth and per share analysis

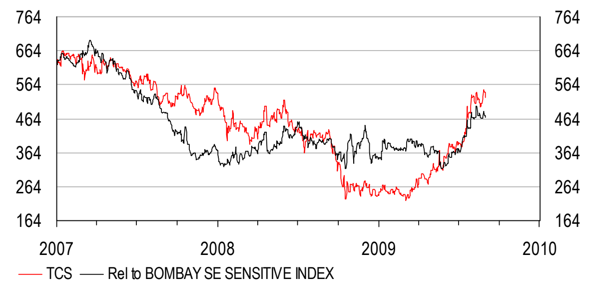
Year to	03/2009a	03/2010e	03/2011e	03/2012e
Y-o-y % change				
Revenue	21.6	5.9	11.4	11.2
EBITDA	20.4	7.5	11.0	10.7
Operating profit	22.6	7.1	11.7	10.7
PBT	5.2	18.2	12.3	13.4
HSBC EPS	4.6	13.4	11.2	8.0
Ratios (%)				
Revenue/IC (x)	2.3	2.0	2.0	2.1
ROIC	46.8	40.0	40.2	39.2
ROE	37.5	33.5	29.9	26.7
ROA	26.5	24.6	23.3	21.3
EBITDA margin	25.8	26.2	26.1	26.0
Operating profit margin	23.8	24.0	24.1	24.0
EBITDA/net interest (x)				
Net debt/equity	-23.9	-32.4	-39.3	-45.6
Net debt/EBITDA (x)	-0.5	-0.8	-1.1	-1.4
CF from operations/net debt				
Per share data (INR)				
EPS reported (fully diluted)	26.86	30.45	33.86	36.56
HSBC EPS (fully diluted)	26.86	30.45	33.86	36.56
DPS	12.50	8.00	9.14	9.87
Book value	81.63	103.24	126.76	152.12

Valuation data

Year to	03/2009a	03/2010e	03/2011e	03/2012e
EV/sales	3.6	3.3	2.9	2.5
EV/EBITDA	13.9	12.6	10.9	9.5
EV/IC	7.1	6.3	5.6	5.0
PE*	19.6	17.3	15.6	14.4
P/Book value	6.5	5.1	4.2	3.5
FCF yield (%)	4.6	4.9	5.1	5.4
Dividend yield (%)	2.4	1.5	1.7	1.9

Note: * = Based on HSBC EPS (fully diluted)

Price relative



Source: HSBC

Note: price at close of 01 Sep 2009

Solid defensive investment

We prefer companies with the right blend of structural growth services, sector-specific exposure, and cyclical services portfolio. While structural growth stories resulting from offshore traction in IMS and regions such as India and higher exposure to sectors leading the recovery (such as BFSI) appear likely to outperform in the near term, companies with higher exposure to cyclical SAP services should have accelerated growth in FY11.

Although we highlighted TCS's defensive revenue profile of TCS (65-70% from BFSI, Retail, utilities and India) in our 20 July note, *TCS: N(V): Solid defensive investment*, in this note we highlight the stability in the telecom market and for TCS, which we believe strengthens our thesis for outperformance:

- TCS has a defensive revenue profile. We expect sequential growth in BFSI, Retail, utilities, and India and stable Telecom. The offshore transition, which was the primary reason for strong volume growth in 1Q, appears likely to continue, as there is further scope of offshoring in mature accounts.
- Margin expansion as volume growth improves.
- Benefits from vendor consolidation should continue.
- INR/USD outlook remains bearish.
- Valuation gap should shrink further.

BFSI: Modest growth in the near term; larger players well-placed until megadeal signings improve

In our conversations with industry participants, they suggested increasing stability in the BFSI market and a pickup in discretionary spending, albeit patchily so far. However, in our conversation with Infosys's US BFSI head, Shaaji Farooq, he said FY11 growth acceleration would depend on the rate of megadeal signings. We believe that top vendors such as TCS and Infosys, while they might be able to achieve historical growth rates in FY11, vendor consolidation is still the theme, and scale players such as TCS should continue to outperform.

Telecom market appears stable for the near term

Based on our recent conversation with Ravi Vishwanathan, head of TCS telecom, we expect flat quarters ahead for the telecom exposure of the top Indian vendors, balanced by cross-currents such as further downward pressure in BT; lesser scope of cost efficiency-driven outsourcing in telecom services providers (TSPs) in mature markets; low capex visibility in the TSP market, but positively offset by increased efficiency-driven offshoring by telecom equipment providers (TEMs); and increased traction in emerging markets such as India, the Middle East, and Latam.

Telecom services providers, or TSPs (c60% of total telecom business for TCS) appear likely to remain flat at best, as clients are running at high efficiency and capex is largely on hold. Incremental spending by clients would have to be driven by incremental capex, which might take longer. While there are opportunities in emerging markets – India, the Middle East, and Latam – any volume growth could come at much lower profitability (c600bps lower than mature markets), and the company prefers increased due diligence before accepting deals in these markets.

Telecom equipment manufacturers, or TEMs, have a buoyant market, compared to TSPs, as there is still material scope to improve operational efficiencies with clients. Clients, especially in the European region (in Finland, Sweden, and France), are looking to increase outsourcing and offshoring, and the company expects moderate sequential growth from this section of the telecom market.

Vendor consolidation: This has been occurring in the telecom market, and the company expects a further scope of vendor consolidation, primarily in the TEM market.

Budget in 4QCY09: In line with our previous conversations with industry officials, Ravi Vishwanathan did not expect any significant budget outlays this year-end. Budgets this year have been revisited more often than in previous years, and are often managed directly by CFOs.

Margins should remain strong as utilisation picks up with improving volumes

TCS's utilisation (including trainees) has fallen by c450bps in the past five quarters as volumes have remained under pressure. However, we believe that as volume growth improves, utilisation should improve, resulting in margin expansion. Management said in our conversations that there is a strong focus on training of employees on the bench to improve their movement across technologies and skill sets and to improve employee usability across divisions as growth expands.

Currency, INR/USD, seems likely to remain a tailwind

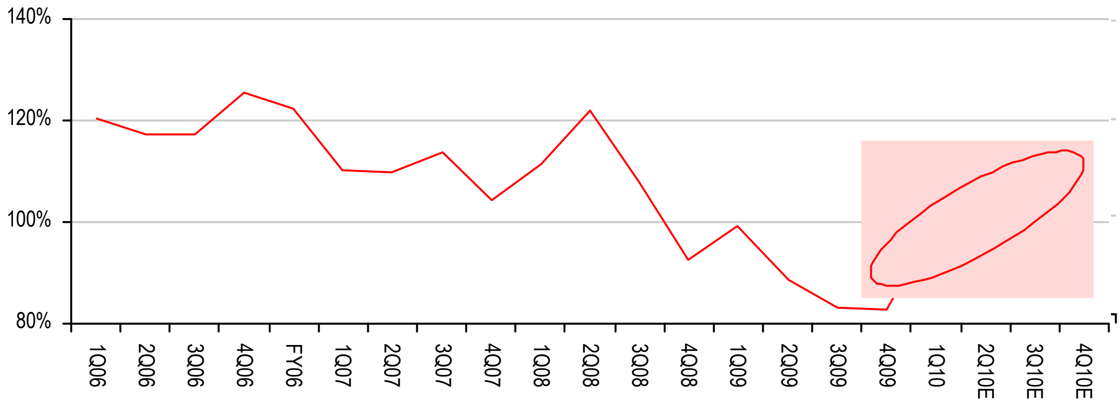
Though we don't forecast currency movements in our models and we assume a flat INR/USD rate, HSBC's Asia FX strategy analyst Richard Yetsenga expects the USD-INR will hold its 47.5-49 range in the very short term, as risks are strongly skewed in favour of rupee weakness. Some of the concerns are that India's budget deficit in fiscal 2010 as forecast by HSBC economists will be one of the largest on record at 7.0% of GDP (for the central government); foreign ownership in the equity market is back close to pre-crisis highs; and seasonal rainfall is significantly below normal this year and this has already worsened trade-offs between inflation, growth, the current account, and the fiscal deficit. The HSBC FX team's forecast of the INR/USD rate is 48 for Q209 and 54 for Q309. (For details, see *Asia FX: INR tail risks rising,* by Richard Yetsenga, 1 September 2009).

Valuation and risks

We value IT companies on a relative valuation basis, underpinned by a fundamental DCF analysis, and with reference to their historical trading ranges and beta to the market. We use WACC of 13% and terminal growth rate of 5%. We are raising our 12-month target price on TCS shares to INR640 from INR480. At our new target price, the stock is valued at a PE of 19x on our FY11e earnings, a 5% discount to Infosys. Our DCF-based target price factors in FY10-19e sales CAGR of c16.8% and an average EBIT of 22.2%. Under our research model, for stocks with a volatility indicator, the Neutral band is 10 percentage points above and below our hurdle rate for Indian stocks of 10.5% or 0.5-20.5% around the current share price. Our new target price of INR640 suggests a potential total return of 21.4%, which is above the Neutral band; thus we are upgrading our rating to Overweight (V) from Neutral (V).

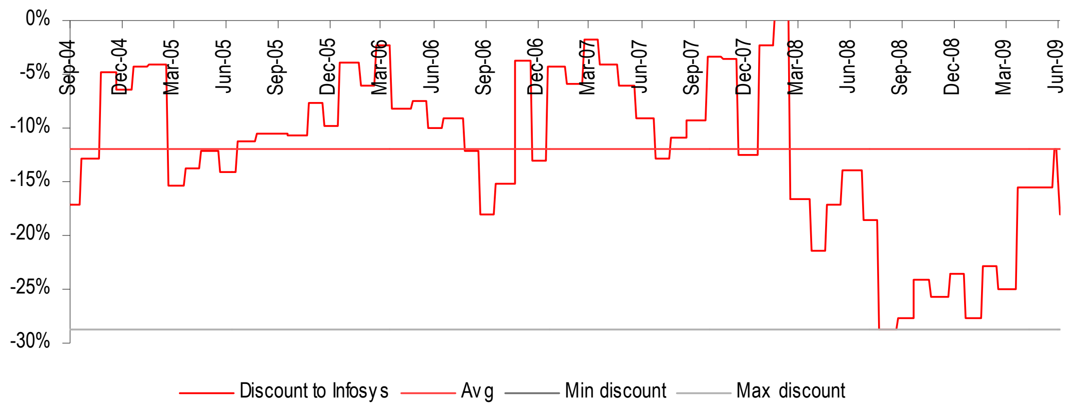
Downside risks, in our view, include the demand environment's deteriorating further, a pricing decline's continuing through FY10, margin contraction due to transition costs for megacontracts, and INR depreciation that results in higher hedging losses.

Tata Consultancy Services: Earnings performance relative to Infosys (TCS net profit/Infosys net profit)



Source: Company reports, HSBC

Tata Consultancy Services: Valuation discount to Infosys (12-month forward PE) should decline further



Source: DataStream, HSBC

Tata Consultancy Services: Changes to our forecasts

	Old estimates		New estimates		Difference	
	FY10	FY11	FY10	FY11	FY10	FY11
Revenues (USDm)	5,980	6,513	6,041	6,727	1.0%	3.3%
Revenues (INRm)	291,424	317,388	294,422	327,848	1.0%	3.3%
EBIT	67,046	69,825	70,740	79,011	5.5%	13.2%
EBIT margin	23.0%	22.0%	24.0%	24.1%	102bp	210bp
EPS (GAAP, INR)	28.9	30.0	30.5	33.9	5.3%	13.0%

Source: HSBC estimates

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Disclosure appendix

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HSBC assigns ratings to its stocks in this sector on the following basis:

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*A stock will be classified as volatile if its historical volatility has exceeded 40%, if the stock has been listed for less than 12 months (unless it is in an industry or sector where volatility is low) or if the analyst expects significant volatility. However, stocks which we do not consider volatile may in fact also behave in such a way. Historical volatility is defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility has to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

Prior to this, from 7 June 2005 HSBC applied a ratings structure which ranked the stocks according to their notional target price vs current market price and then categorised (approximately) the top 40% as Overweight, the next 40% as Neutral and the last 20% as Underweight. The performance horizon is 2 years. The notional target price was defined as the mid-point of the analysts' valuation for a stock.

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Prior to 15 November 2004, HSBC's ratings system was based upon a two-stage recommendation structure: a combination of the analysts' view on the stock relative to its sector and the sector call relative to the market, together giving a view on the stock relative to the market. The sector call was the responsibility of the strategy team, set in co-operation with the analysts. For other companies, HSBC showed a recommendation relative to the market. The performance horizon was 6-12 months. The target price was the level the stock should have traded at if the market accepted the analysts' view of the stock.

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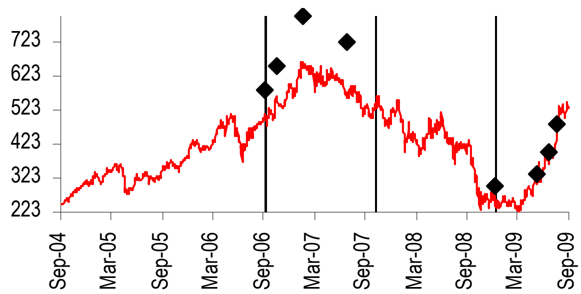
Overweight (Buy)	35%	(34% of these provided with Investment Banking Services)
Neutral (Hold)	42%	(29% of these provided with Investment Banking Services)
Underweight (Sell)	23%	(30% of these provided with Investment Banking Services)

Share price and rating changes for long-term investment opportunities

TCS (TCS.BO) Share Price performance INR Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Overweight	04 September 2006
Overweight	N/A	04 October 2007
N/A	Neutral (V)	10 December 2008
Target Price	**Value**	**Date**
Price 1	580.00	04 September 2006
Price 2	650.00	16 October 2006
Price 3	800.00	16 January 2007
Price 4	725.00	29 June 2007
Price 5	N/A	04 October 2007
Price 6	300.00	10 December 2008
Price 7	335.00	12 May 2009
Price 8	400.00	25 June 2009
Price 9	480.00	20 July 2009

Source: HSBC

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
TCS	TCS.NS	527.05	31-Aug-2009	4

Source: HSBC

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