

Tata Consultancy Services (TCS)

Rs 800

WHAT'S CHANGED...

PRICE TARGET Changed from Rs 870 to Rs 924
EPS (FY11E) Changed from Rs 39.0 to Rs 39.6
EPS (FY12E) Changed from Rs 43.1 to Rs 44.0
RATING..... Changed from Add to Buy

Operational exuberance continues...

TCS reported Q4FY10 numbers that underperformed Street and our revenue expectations but outperformed extensively on margins. It attained a historical high in EBITDA margin at 29.9% demanding a further bridge in valuation gap compared to Infosys. TCS announced 10 large deals of US\$50-500+ million sizes, which were spread across verticals and geography. Overall, the management sounded optimistic about the demand scenario and indicated that it will still continue with its prudent cost management programme to counter currency as well as wage hike headwinds, thus guiding on maintaining operational margins at 27%. Also, initial hiring was indicated at 30,000 for FY11.

■ Mixed bag results but exceptionally well operational performance

The company reported revenues at Rs 7,736 crore (ICICIdirect.com estimate: Rs 7,894 crore) with mere growth of 1.1% QoQ. This was on the back of moderate volume growth of 4.1% and harsh cross-currency impacting -3.1% QoQ. However, all these just got overshadowed with an exceptionally well operational performance yet again increasing EBIT margins by 21 bps QoQ taking it to an all-time high of 27.5%. Also, the PAT came in much higher at Rs 1,932 crore with 7.5% QoQ growth on the back of forex gain and high year-end investment income. Clearly, BFS aided the growth but this time even insurance contributed. The company indicated that client budgets have closed on a positive note in most sectors and expect the telecom sector to also add to growth, going forward. Manufacturing is out of the woods for the company but the growth is expected to be sluggish in this sector. TCS also announced an impressive wage hike of 10% offshore (i.e. 13% with variable payout) and 2-4% onsite. Overall, the tone of the management was pretty optimistic.

Valuation

On the back of its strong foothold in BFSI and the government sector as well as a fairly diversified vertical mix, service mix as well as geographic mix, we believe the company will continue to be the frontrunner in the IT pack and expect 20% CAGR revenue growth over FY10-FY12E. With the management bridging the margin gap with Infosys we are also scaling down the PE (x) discount from 10% to 5% and valuing the stock at 21x FY12E EPS of Rs 44.0 i.e. at Rs 924 with **BUY** rating.

Exhibit 1: Performance Highlights

(Rs Crore)	Q4FY10	Q4FY10E	Q4FY09	Q3FY10	QoQ(Ch %)	YoY(Ch%)
Net Sales	7,736.5	7,897.4	7,172.2	7,649.9	1.1	7.9
EBITDA Margin (%)	29.9	29.0	26.2	29.7	19 bps up	367 bps up
Depreciation	184.1	177.7	179.6	182.9	0.7	2.5
Other Income	163.6	85.0	(137.4)	56.9	187.5	
Reported PAT	1,931.5	1,829.0	1,314.1	1,797.2	7.5	47.0
EPS (Rs)	9.9	9.4	6.7	9.2	7.5	47.0

Source: Company, ICICIdirect.com Research

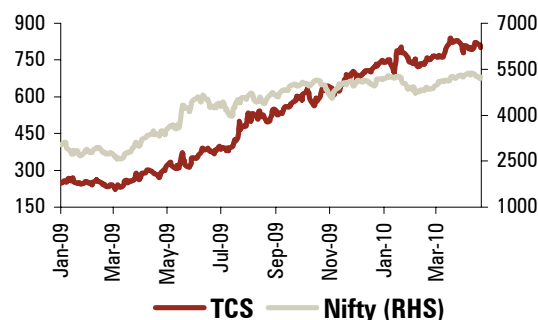
Rating matrix	
Rating	: Buy
Target	: Rs 924
Target Period	: 12 months
Potential Upside	: 15%

Annual performance				
	FY09	FY10	FY11E	FY12E
Net Sales	27,813.3	30,027.9	33,585.2	39,726.9
EBITDA	7,178.0	8,678.8	9,707.1	11,156.4
EBITDA margin(%)	25.8	28.9	28.9	28.1
Net Profit	5,171.6	6,872.6	7,741.3	8,610.3
EPS	26.4	35.1	39.6	44.0

Valuation summary				
	FY09	FY10	FY11E	FY12E
PE (x)	30.3	22.8	20.2	18.2
Target PE (x)	35.0	26.3	23.4	21.0
EV to EBITDA (x)	20.7	17.1	15.3	13.3
Price to book (x)	10.0	7.6	6.0	4.9
RoNW (%)	33.2	33.7	29.9	27.0
RoCE (%)	39.6	37.1	33.0	31.1

Stock data	
Market Capitalisation	Rs 156576 crore
Debt (Q4FY10)	Rs342 crore
Cash (Q4FY10)	Rs 8670 crore
EV	Rs148248 crore
52 week H/L	844/264
Equity capital	Rs 196 Crore
Face value	Rs. 1
FII Holding (%)	12.3
DII Holding (%)	7.9

Price movement (Stock vs. Nifty)



Analyst's name

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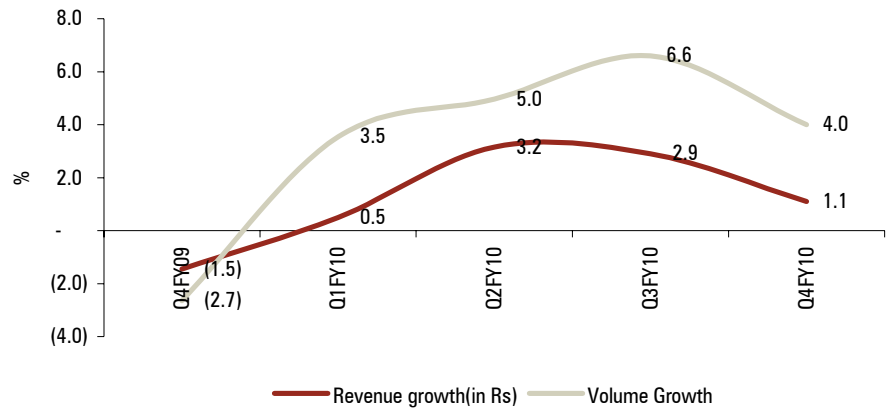
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The company started demonstrating strong volume led growth from Q1FY10 with its peak in Q3FY10. The volume growth for Q4Y10 was at 4.0% (ICICIdirect.com estimate: 5.5%). This resulted in rupee terms revenue growth being muted at 1.1% QoQ, further dragged down by steep appreciation of the US\$ against the GBP and Euro as well as INR against US\$

The company was confronted with pricing erosion in FY10 with 3.3% de-growth YoY primarily witnessed in YTD FY10. However, in Q4FY10 the company managed a marginal improvement in revenue productivity by 5 bps as compared to Infosys with 70 bps (CC-QoQ drop). Going forward, the management has indicated that they expect price points to remain flat in the near term and anticipates that it will inch up by Q1CY11 as the demand scenario improves

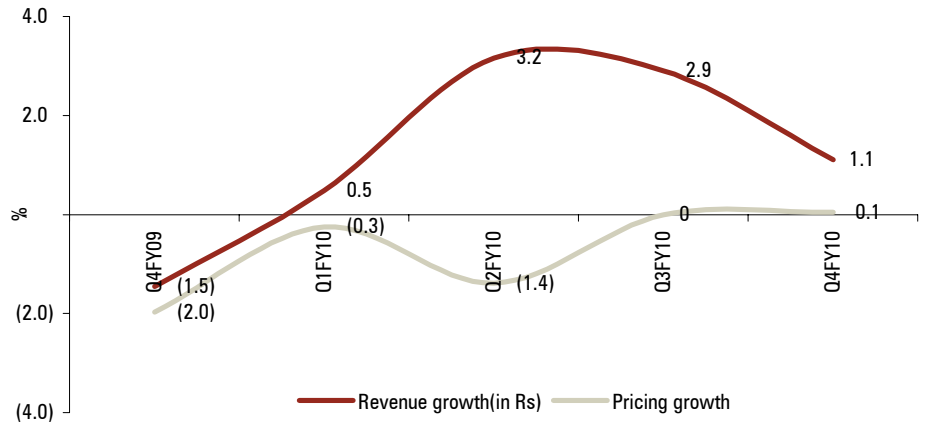
Cross-currency headwinds have proved to be a spoilsport with the US\$ appreciating steeply against the GBP and Euro by 4.3% and 6.3% QoQ leading to lower dollar realisation. In addition, the INR appreciated 1.5% QoQ against the US\$ resulting in 3.1% lower revenue realisation mopping up all the gains of decent volume growth

Exhibit 2: Impact of volume on revenue



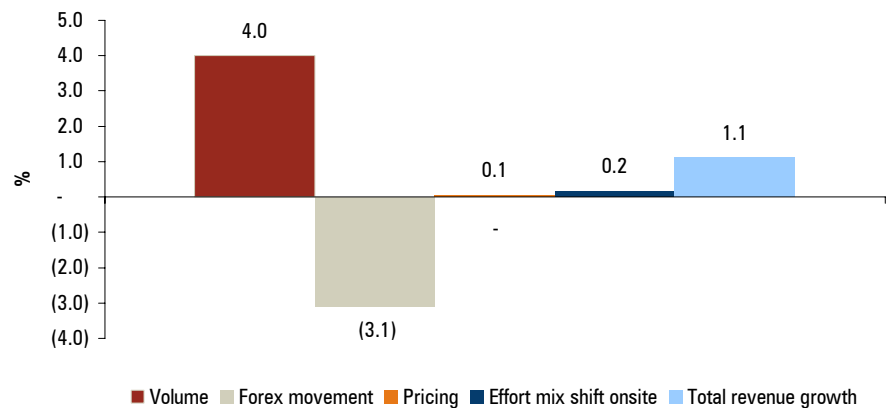
Source: Company, ICICIdirect.com Research

Exhibit 3: Impact of pricing on revenue



Source: Company, ICICIdirect.com Research

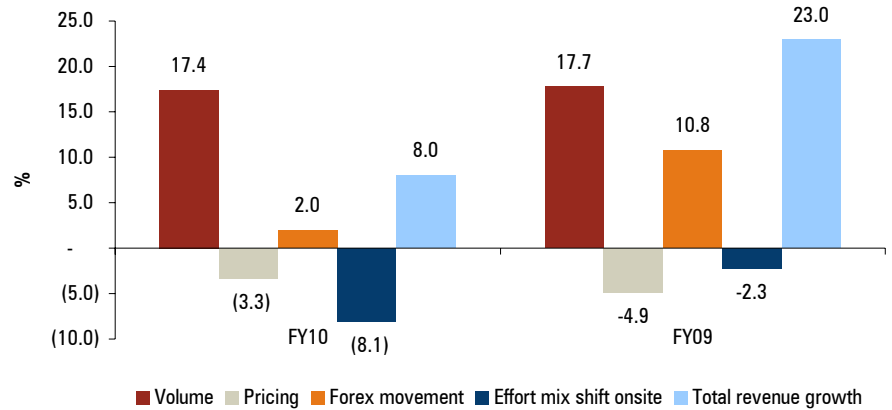
Exhibit 4: Factors driving revenue growth for Q4FY10



Source: Company, ICICIdirect.com Research

Clearly, more offshoring of volume led the revenue growth in FY10 offsetting the effects of 3.3% YoY de-growth in pricing. In addition, higher rupee realisation of 47.4 for INR/US\$ (in FY10) vs. 46.3 for INR/US\$ (in FY09) aided revenue growth of 8% YoY

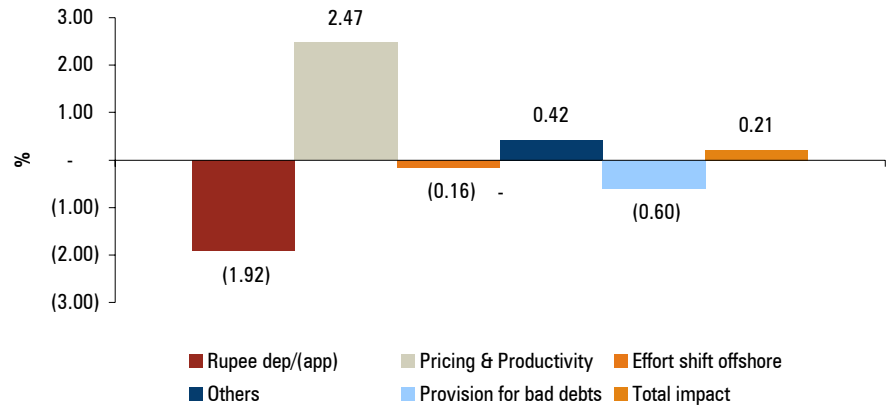
Exhibit 5: Factors driving revenue growth for FY10 vs. FY09



Source: Company, ICICIdirect.com Research

The company managed to pull up its operating margin yet again by 21 bps on the back of a series of sizeable improvements of 103 bps, 144 bps and 113 bps in Q3FY10, Q2FY10 and Q1FY10, respectively. The management continued with its operational exuberance again offsetting the harsh effect of cross-currency volatility primarily on the back of spectacular improvement in its productivity. This has been possible due to the aggressive cost rationalisation programme taken up by the management involving scaling down of general & administration expenses, improving productivity as well as pulling up the offshore leverage extensively

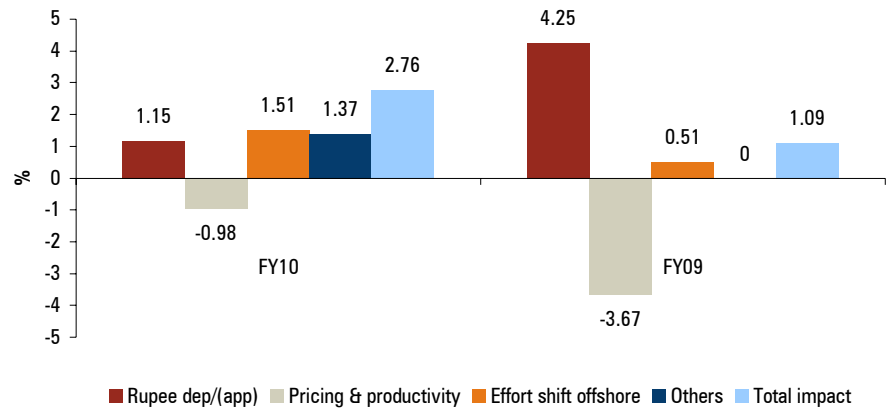
Exhibit 6: Factors affecting EBIT margin for Q4FY10



Source: Company, ICICIdirect.com Research

The company's cost rationalisation programme has changed the profitability landscape for the company improving its EBIT margin by 276 bps YoY peaking to a lifetime high of 27.5 % (in Q4FY10) as compared to 23.7% and 22.3% in Q4FY09 and Q4FY08, respectively. Clearly, the management did pull up its levers like offshoring more work, reducing the cost of revenue by improving productivity negating the effect of a drop in pricing by 3.3% YoY. The management has indicated wage hike of 10% offshore and 2-4% onsite in FY11 effective April 2010. This will impact the margins heavily. Even then, the management is aiming to maintain the EBIT margins for FY11 at 27% absorbing the wage hike impact by productivity lever and assuming the rupee stabilises at 46 for INR/US\$ for the entire year

Exhibit 7: Factors affecting EBIT margin for FY10 vs. FY09



Source: Company, ICICIdirect.com Research

The top client contribution has scaled up by 350 bps YoY on account of the increased engagement with Citigroup post-CGSL acquisition. Client addition remained robust at 39 and was broad based

Exhibit 8: Client metrics

	Q4FY09	Q1FY10	Q2FY10	Q3FY10	Q4FY10
Top Client contribution(%)	4.7	5.7	6.8	8.1	8.2
Number of active clients	985	933	896	917	917
Clients added	36	26	30	32	39

Source: Company, ICICIdirect.com Research

The company has shown commendable improvement in its top end of the client pyramid i.e. US\$10 million plus specially US\$100 million plus and US\$20-50 million

Exhibit 9: Client pyramid

	Q4FY09	Q3FY10	Q4FY10
USD \$1-5 million	233	241	226
USD \$5-10 million	61	66	65
USD\$10-20 million	49	51	55
USD\$20-50 million	38	38	40
USD\$50-100 million	17	17	16
USD \$100 million plus	7	6	7

Source: Company, ICICIdirect.com Research

The company's excluding trainee utilisation peaked at 81.8% whereas including trainee number slumped to 74.3% on the back of 8,500 additional trainees added during Q4FY10

Exhibit 10: Trend in utilisation

	Q4FY09	Q1FY10	Q2FY10	Q3FY10	Q4FY10
Including trainee(%)	69.4	71.3	73.6	77.2	74.3
Excluding trainees(%)	79.7	79.2	79.5	81.1	81.8

Source: Company, ICICIdirect.com Research

The company added a whopping 10,110 people in TCS primarily trainees as well as 665 employees in its subsidiaries. Attrition did inch up marginally to 11% whereas Infosys posted attrition level of 13.4%. The management has indicated that it will hire close to 30,000 employees as of now for FY11, which includes 20,000 campus offers. This hiring number may inch up further as discretionary spend comes back to map with growth in volumes

Exhibit 11: Employee metrics

	Q4FY09	Q1FY10	Q2FY10	Q3FY10	Q4FY10
TCS Ltd					
Attrition% (IT services)	10.5	10.7	10.8	10.8	11.0
Gross addition	3522	1154	3836	11377	14640
Net addition	521	-2746	-312	7417	10110
Subsidiaries					
Attrition% (BPO)	21.6	19.8	18.0	18.3	18.8
Net addition	12897	627	632	275	665

Source: Company, ICICIdirect.com Research

Valuation

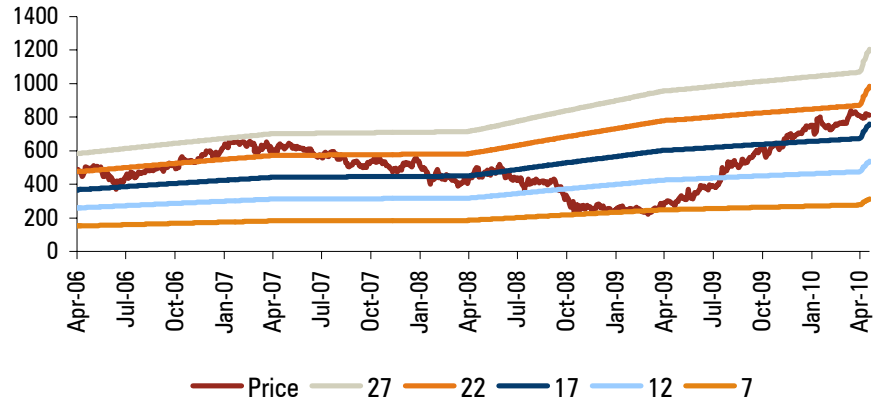
The management has indicated that they are seeing the comeback of large deals. They have bagged 10 large deals in Q4FY10, one at more than US\$500 million while the rest are in the US\$50-150 million bracket spread across verticals and geography. The management has demonstrated prudent cost management with 276 bps YoY expansion in EBIT margins taking it to the historic high of 27.5%. Even after giving a wage hike of 10% offshore (i.e. 13% with variable payout) and 2-4% onshore the company is confident of maintaining EBIT at 27% for FY11 assuming the rupee stays at 46 for INR/US\$. Also, post the client budgeting the management is looking at growth beyond BFSI also i.e. from retail, government, healthcare, energy & utilities as well as telecom and expects manufacturing to remain a little sluggish.

Overall, the management sounded very optimistic about growth as well as profitability and has identified levers like productivity to counter any headwinds due to currency or wage hike. Thus, we are outlining the company will grow at 20% CAGR over FY10-FY12E. We are upgrading our EPS for FY11 and FY12 from Rs 39 to Rs 39.6 and from Rs 43.1 to Rs 44.0, respectively. Rewarding the management's operational exuberance we value the company at a mere 5% discount (as compared to 10%

before) to Infosys i.e. 21x FY12E EPS with a target price of Rs 924 and **BUY** rating.

The stock is trading at 20.2x FY11 and 18.2x FY12 EPS of Rs 39.6 and Rs 44.0, respectively

Exhibit 12: One year forward PE(x) chart



Source: Company, ICICIdirect.com Research

Risk & Concerns

We have built in the assumption of average of 44.5 for INR/US\$ and 43.5 for INR/US\$ for FY11 and FY12, respectively. If the rupee appreciates against the US dollar steeply then we will have to revise our estimates downwards.

ICICIdirect.com Coverage Universe

				Sales (Rs Cr)	EPS (Rs)	PE (x)	EV/EBITDA (x)	RoNW(%)	RoCE(%)
Infosys									
Idirect Code	INFTEC	CMP(Rs)	2728.0 FY09	21693.5	104.6	26.1	19.8	32.8	37.9
		Target(Rs)	3092.0 FY10	22742.1	109.5	24.9	18.1	26.9	34.2
Mcap(crore)	156423.52	Upside(%)	13.3 FY11E	26110.5	117.7	23.2	16.3	24.7	32.9
			FY12E	30780.5	140.6	19.4	14.0	25.0	33.3
HCL Technologies									
Idirect Code	HCLTEC	CMP(Rs)	349.0 FY09	10630.5	19.0	18.4	10.3	22.5	14.9
		Target(Rs)	399.0 FY10E	12130.7	17.4	20.1	9.4	18.9	15.6
Mcap(crore)	23423.2688	Upside(%)	14.3 FY11E	13196.6	24.2	14.4	8.6	22.4	14.9
			FY12E	15088.4	27.5	12.7	7.8	21.5	15.2
Tech Mahindra									
Idirect Code	TECHM	CMP(Rs)	825.3 FY09	4464.8	77.4	10.7	9.2	52.2	65.6
		Target(Rs)	923 FY10E	4534.1	58.2	14.2	10.8	19.7	28.7
Mcap(crore)	10068.05	Upside(%)	11.8 FY11E	4824.9	80.0	10.3	11.0	28.5	23.0
			FY12E	5515.2	74.5	11.1	10.1	21.0	23.3
Wipro									
Idirect Code	WIPRO	CMP(Rs)	700.0 FY09	25699.5	26.7	26.2	20.0	28.6	23.3
		Target(Rs)	755.3 FY10E	27266.6	31.4	22.3	17.4	26.4	22.4
Mcap(crore)	102550	Upside(%)	7.9 FY11E	31136.8	34.3	20.4	15.5	23.3	21.4
			FY12E	36283.2	38.6	18.1	13.4	21.6	21.3
Patni Computers									
Idirect Code	PATCOM	CMP(Rs)	565.0 CY09	3146.1	45.0	12.5	8.4	16.5	13.4
		Target(Rs)	570.0 CY10E	3306.1	39.9	14.2	7.6	13.2	13.3
Mcap(crore)	7260.25	Upside(%)	0.9 CY11E	3624.0	41.1	13.7	7.0	12.1	12.9
			CY12E	4034.0	44.2	12.8	6.4	11.6	12.8
3i Infotech									
Idirect Code	3IINFO	CMP(Rs)	77.0 FY09	2285.6	16.1	4.8	7.5	29.4	10.8
		Target(Rs)	89.1 FY10E	2436.1	14.5	5.3	6.8	16.6	11.1
Mcap(crore)	1296.7	Upside(%)	15.7 FY11E	2632.8	11.6	6.6	6.3	14.4	11.3
			FY12E	2874.4	12.7	6.0	5.9	13.7	11.2
Rolta									
Idirect Code	ROLIND	CMP(Rs)	184.2 FY09	1372.8	18.2	10.1	8.7	22.7	15.7
		Target(Rs)	226.0 FY10E	1560.8	16.6	11.1	6.8	17.8	13.4
Mcap(crore)	2965.6	Upside(%)	22.7 FY11E	1822.9	18.9	9.7	5.7	18.3	14.9
			FY12E	2102.4	22.6	8.2	4.9	18.4	16.4
KLG Systel									
Idirect Code	KLGSYS	CMP(Rs)	129.0 FY09	234.8	23.0	5.6	3.6	16.0	27.1
		Target(Rs)	198.4 FY10E	231.4	17.1	7.5	3.2	11.0	28.9
Mcap(crore)	151.7	Upside(%)	53.8 FY11E	248.0	23.1	5.6	2.9	13.4	29.4
ICSA									
Idirect Code	INNCOM	CMP(Rs)	127.4 FY09	1100.4	32.6	3.9	4.4	26.3	23.6
		Target(Rs)	190.1 FY10E	1264.8	26.6	4.8	4.2	18.8	19.2
Mcap(crore)	600.1	Upside(%)	49.2 FY11E	1597.0	34.9	3.7	3.2	19.9	22.0
			FY12E	2089.4	52.6	2.4	2.3	23.4	26.7
Mastek									
Idirect Code	MASTEK	CMP(Rs)	294.9 FY09	942.6	52.5	5.6	4.1	31.3	24.4
		Target(Rs)	295.0 FY10E	713.2	27.9	10.6	6.8	14.2	12.1
Mcap(crore)	793.3	Upside(%)	0.0 FY11E	755.9	31.1	9.5	5.7	14.3	14.9
NIIT									
Idirect Code	NIIT	CMP(Rs)	68.1 FY09	1168.5	4.2	16.1	12.2	15.8	16.5
		Target(Rs)	75.5 FY10E	1234.4	4.1	16.6	9.3	13.8	18.0
Mcap(crore)	1120.2	Upside(%)	10.9 FY11E	1356.9	5.5	12.3	7.5	17.0	20.7
			FY12E	1514.1	6.8	10.0	6.4	18.4	22.3
Firstsource Solution									
Idirect Code	FSSOL	CMP(Rs)	31.1 FY09	1749.7	0.7	42.8	11.0	2.2	5.0
		Target(Rs)	38.3 FY10E	1953.1	3.1	9.9	9.1	8.9	6.5
Mcap(crore)	1334.2	Upside(%)	23.1 FY11E	2057.1	3.6	8.6	8.2	9.3	7.0
			FY12E	2352.9	4.4	7.1	6.7	10.1	10.0

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 Add: Up to 10%;
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 Sell: -10% or more;

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