

TATA CONSULTANCY SERVICES

INR 1,328

*First to cross yet another milestone*

BUY

Tata Consultancy Services (TCS) announced its Q3FY07 results, which were impressive and in line with our expectations. Revenues were at INR 48.6 bn, up 8.4% Q-o-Q, and net profit was at INR 11 bn, up 11.4% Q-o-Q. On Y-o-Y basis, revenue and net profit growth stood at 40.7% and 50.9%, respectively. The company achieved a milestone by crossing USD 1 bn in revenues and USD 250 mn in net profits in a quarter. Healthy growth across service lines projects a strong demand scenario and better pricing power. TCS' existing realisations have room for expansion and the company is making the best use of the demand environment.

TCS' margin expansion yet again in the current quarter re validate our positive stance on the company. With further scope for an increased offshore revenue mix as the quarters progress and continued upscale in the possibility of strong volume growth, billing rate hikes, we believe there are a lot of levers still available for the company. In addition, factors such as employee pyramid optimisation, maturing of new services like infrastructure management, and increasing profitability in acquired businesses and large deals will drive margin upwards.

Based on these arguments, we are reiterating our 'BUY' recommendation on the stock. We recommend buying into the stock with 12-month P/E range expectations of 23x-26x, implying 10-15% returns from the current levels.

Key Highlights

- Revenues reported at INR 48.6 bn, up 8.4% Q-o-Q and 48.9% Y-o-Y, while the net profit stood at INR 11 bn, up 11.4% Q-o-Q and 50.9% Y-o-Y.
- Gross profit stood at INR 22.8 bn, up 9.1% Q-o-Q and 44.3% Y-o-Y. Gross margin expanded by 30bps Q-o-Q on the back of improvement in utilisaiton and higher offshore revenues.
- EBITDA stood at INR 13.8 bn, registering an impressive Q-o-Q growth of 11.9%. EBITDA margins increased by 90bps Q-o-Q to 28.3%. The expansion in the EBITDA margins was on account of higher proportion of offshore revenues (60bps) in the total revenue mix, currency impact (-137bps), operating efficiencies, and better cost management.

Financials

Year to March	Q3FY07	Q2FY07	Growth %	Q3FY06	Growth %	FY07E	FY08E
Revenue (INR mn)	48,605	44,822	8.4	32,646	48.9	186,295	245,594
EBITDA (INR mn)	13,753	12,294	11.9	9,516	44.5	51,793	69,021
Net profit (INR mn)	11,047	9,915	11.4	7,319	50.9	42,240	55,052
EPS (INR)	11.3	10.1	11.4	7.6	48.2	43.2	56.2
P/E (x)						30.8	23.6
EV/EBITDA (x)						24.8	18.4
Mkt. cap/ Revenue						7.0	5.3

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Market Data

52-week range (INR) : 2,099 / 900
Share in issue (mn) : 978.8
M cap (INR bn/USD mn) : 1,300/29,149
Avg. Daily Vol. BSE/NSE ('000) : 1,391.5

Share Holding Pattern (%)

Promoters : 82.5
MFs, Fls & Banks : 4.4
Fls : 7.0
Others : 6.2

- ◆ Utilisation, including and excluding trainees, stood at 75% and 78.2% compared with 75.2% and 79.4% in the previous quarter, respectively.
- ◆ Employee head count continued to remain strong. This quarter the company added a gross of 7,835 (net 5,472) employees. The company's total headcount now stands at 83,500 employees.
- ◆ Attrition stood at 10.8% as against 10.6% in the previous quarter and 7.6% a year ago.
- ◆ The company added 55 new clients during the quarter. The active client count for the company stands at 754 compared with 742 in the previous quarter.
- ◆ The company now has 288 customers contributing revenues greater than USD 1 mn and 15 customers with an annual run rate of USD 50 mn plus.
- ◆ Strong revenue growth momentum is led by verticals such as life sciences and healthcare (up 22% Q-o-Q), retail and distribution (up 13.4% Q-o-Q), BFSI (up 10.5% Q-o-Q on a base of USD 414 mn), and Telecom (9.7% Q-o-Q).

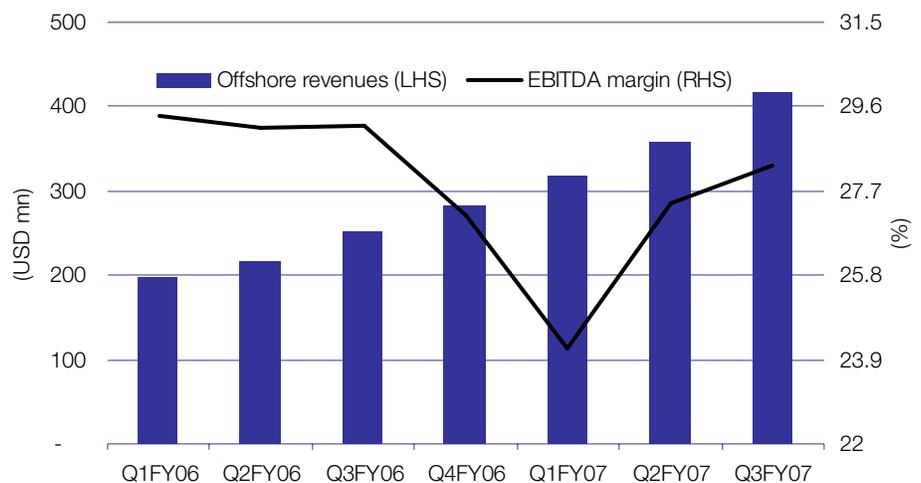
*** Client mining continues its uptrend**

TCS's client addition continues to be on an uptrend. This quarter too the company's top clients have performed well, with the top five clients growing 48% Y-o-Y and the top ten growing 47.8% (both in excess of 40% for the third time consecutively). Being India's oldest, largest, and best known IT services company, TCS is well-positioned to post sustained growth over the next three to four years. The management has indicated that the current demand environment is the strongest, which clearly reflects in the five large deals won by the company during the quarter (two USD100 mn and three USD 50 mn deals).

*** Increased offshore revenues leading to better profitability**

TCS has been steadily increasing its offshore revenue mix over the past several quarters. This quarter the same increased to 41.6% from 41.0% in the previous quarter. With its peers deriving almost 50% of the revenues from offshore, we believe there is a lot of potential left for TCS. This increase is also enabling it to drive better profitability.

Chart 1: Offshore revenues and EBITDA margins



Source: Company, Edelweiss research

* **Strong volume growth yet again**

TCS reported 8.4% Q-o-Q and 48.9% Y-o-Y growth in revenues this quarter. Over the past 5 quarters the company has successfully grown its volumes in double digit in 3 quarters. Q3FY07 too witnessed a strong volume growth – almost 8% Q-o-Q. Besides, positive comments by the management as regards the pricing scenario boosts our confidence in the company's potential. TCS has stated that it is getting a 3-5% increase in pricing from renewal contracts for the existing clients and a heady 5-10% increase in billing rate from new clients.

* **Valuations**

We forecast TCS to post healthy EPS growth of 37.8% over FY06-08E. The company's leading position, healthy EPS growth, and appreciation of strengths will be the key factors helping it improve its forward P/E band.

At CMP of INR 1,328 the stock trades at a PE of 30.8x and 23.6x for our FY07E and FY08E earnings estimate respectively. We are reiterating our '**BUY**' recommendation on the stock. We recommend buying into the stock with a 12-month P/E range expectation of 23x-26x, implying 10-15% returns from the current levels.

Financial snapshot						(INR mn)		
Year to March	Q3FY07	Q2FY07	Growth %	Q3FY06	Growth %	FY06	FY07E	FY08E
Total revenues	48,605	44,822	8.4	32,646	48.9	126,582	186,295	245,594
Cost of revenues	25,758	23,880	7.9	16,817	53.2	65,638	98,402	128,099
Gross profit	22,847	20,942	9.1	15,829	44.3	60,944	87,893	117,495
SG&A	8,989	8,542	5.2	6,228	44.3	24,323	35,621	47,265
R&D	105	106	(1.3)	85	23.2	420	479	1,210
EBITDA	13,753	12,294	11.9	9,516	44.5	36,201	51,793	69,021
Depreciation and amortization	1,080	958	12.7	701	54.0	2,691	3,949	5,045
EBIT	12,673	11,336	11.8	8,815	43.8	33,510	47,844	63,976
Other income	300	77	287.7	(197)	(252.3)	8	1,180	720
PBT	12,972	11,413	13.7	8,618	50.5	33,518	49,024	64,696
Tax	1,828	1,447	26.3	1,254	45.7	4,714	6,454	9,113
Adjusted net profit	11,144	9,967	11.8	7,363	51.3	28,804	42,570	55,582
Minority interest	(115)	(59)	93.4	(48)	137.7	(280)	(371)	(530)
Equity in net earnings of affiliates	17	8	123.2	4	360.9	42	40	-
Extraordinary income/expense	-	-	-	-	-	(232)	-	-
Reported net profit	11,047	9,915	11.4	7,319	50.9	28,334	42,240	55,052
EPS - basic	11.3	10.1	11.4	7.6	48.2	29.6	43.2	56.2
as % of net revenues								
Gross profit	47.0	46.7		48.5		48.1	47.2	47.8
SG&A	18.5	19.1		19.1		19.2	19.1	19.2
EBITDA	28.3	27.4		29.1		28.6	27.8	28.1
Adjusted net profit	22.9	22.2		22.6		22.8	22.9	22.6
Reported net profit	22.7	22.1		22.4		22.4	22.7	22.4
Tax rate	14.1	12.7		14.6		14.1	13.2	14.1

Company Description

TCS is India's largest and among the oldest IT companies which commenced operations in 1968. It provides a comprehensive range of IT services to industries such as banking and financial services, insurance, manufacturing, telecommunications, retail and transportation. With presence in 34 countries, TCS is positioned to deliver its services seamlessly. TCS has a large diversified client base (754 active clients) which includes seven of the Fortune Top 10 companies. TCS' employee force stands at 83,500 and its revenues for the last twelve months (TTM) stood at INR 172.2 bn (USD 3.9 bn).

Investment theme

As India's largest and most experienced IT services firm, TCS is well positioned to benefit from the growing demand for offshore IT services. TCS is a serious contender for winning large deals as it has more experience than any of its peers in implementing large, complex, mission critical projects. TCS has multiple margin levers at its disposal, which we believe, will sustain its margins, shielding it from continued pressures on account of wage increases across the industry. These drivers include transition to offshore, leveraging fixed price business, and higher client mining.

Risks to investment theme

Key risks to our investment theme include – a) sustained slowdown in US, b) maintaining the margins while pursuing large deals, c) Significant increase in the salary hikes and attrition rate creating cost pressures, and d) Any substantial appreciation of rupee against US dollar, Euro and GBP.

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RATING INTERPRETATION

Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period

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