

Telecoms, Media & Technology
 IT Services
 Equity – India

Overweight

Target price (INR)	1600.00
Share price (INR)	1262.00
Potential total return (%)	26.8

Performance	1M	3M	12M
Absolute (%)	-0.3	-4.7	40.4
Relative ^A (%)	-3.3	0.1	17.9

Index^A BOMBAY SE SENSITIVE INDEX

RIC TCS.BO
 Bloomberg TCS IN

Market cap (USDm) 29,454
 Market cap (INRm) 1,235,006

Enterprise value (INRm) 1220354
 Free float (%) 15.2

17 April 2007

Vipin Khare

Analyst

HSBC Securities and Capital Markets

India Private Ltd.

+9122 22681238

vipinkhare@hsbc.co.in

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TCS

Rupee appreciation could dampen near-term performance but outlook for FY08e remains strong

- ▶ **Revenues were in line but net profit was marginally below our and consensus estimates for March 2007 results**
- ▶ **Overall, demand environment remains strong and TCS should continue to witness above-industry revenue and profit growth in FY08-09e**
- ▶ **Maintain Overweight rating and target price of INR1,600**

Overview

Overall: Following the strong USD revenue guidance by Infosys, TCS management reiterated the strong business environment for offshore vendors. However the recent strength in the rupee remains the key risk to rupee revenue growth and margins in FY08e for India IT vendors. Consequently, despite TCS management guiding at stable margins for FY08e, we continue to forecast declining margins for FY08e and FY09e.

Key positives: (1) Management reiterated strong business environment; (2) domestic business revenues (+26%q-o-q, +13%y-o-y); (3) hiring: 12,000 campus offers made for FY08. TCS plans to hire over 32,000 gross employees in FY08;(4) favourable pricing for new and existing clients; (5) higher utilisation at 79.6%; (6) higher contribution from new services like Consulting, Testing, BPO and Infrastructure (c19% of revenues)

Key negatives: (1) Margins declined by c90bp y-o-y for the full year which is towards the higher end of management's revised guidance; (2) TCS's profits are now only +11% higher than Infosys's (c 25%differential two years back) despite revenues being 34% higher; (3) attrition rate increased marginally to 11.3% (c10.6% for only IT Services); (4) sequential decline in financial services (-1%q-o-q) and APAC revenues (-9% q-o-q).

Stock view: Over the last two years, TCS management has aggressively scaled up revenues even at the cost of modestly sacrificing margins. We believe given the strong demand environment for offshore and the scalability, management, and execution experience of TCS, it should continue to witness above-average-industry revenue and profit growth in FY08e. TCS currently trades at 23.5x FY08e and 19x FY09e EPS for earnings growth potential of +27%y-o-y and +24% y-o-y, respectively. Maintain Overweight rating and target price of INR1, 600.

Financials & valuation

Financial statements

	03/2006a	03/2007e	03/2008e	03/2009e
Profit & loss summary (INRm)				
Revenue	132,455	186,165	244,511	312,305
EBITDA	36,947	51,251	66,357	82,425
Depreciation & amortisation	-2,810	-4,029	-5,257	-6,090
Operating profit/EBIT	34,137	47,222	61,100	76,335
Net interest	350	421	640	640
PBT	34,327	48,331	62,230	77,577
HSBC PBT	34,327	48,331	62,230	77,577
Taxation	-4,989	-6,544	-9,212	-12,073
Net profit	29,074	41,454	52,618	65,044
HSBC net profit	29,074	41,454	52,618	65,044

Cash flow summary (INRm)

Cash flow from operations	23,024	24,379	44,121	51,147
Capex	-7,012	-8,597	-8,385	-12,504
Cash flow from investment	-10,089	-11,079	-12,837	-19,014
Dividends	-6,606	-11,743	-14,679	-17,615
Change in net debt	-2,281	-1,911	-20,449	-22,526
FCF equity	16,172	15,094	35,247	38,040

Balance sheet summary (INRm)

Intangible fixed assets	8,692	13,568	13,568	13,568
Tangible fixed assets	15,072	19,639	22,767	29,182
Current assets	49,600	81,435	126,280	187,615
Cash & others	3,965	5,698	26,147	48,673
Total assets	94,318	143,252	196,816	272,460
Operating liabilities	24,675	34,004	44,188	62,879
Gross debt	979	802	802	802
Net debt	-2,986	-4,896	-25,345	-47,871
Shareholders funds	58,408	82,881	122,344	171,128
Invested capital	44,723	74,940	92,279	118,812

Ratio, growth and per share analysis

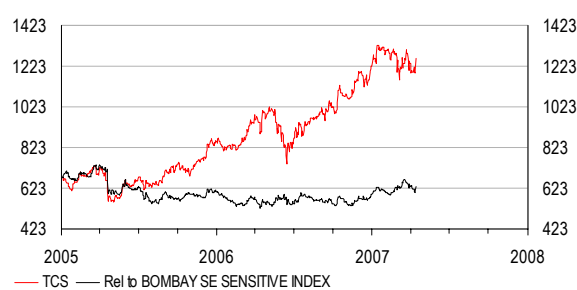
	03/2006a	03/2007e	03/2008e	03/2009e
Y-o-y % change				
Revenue	36.2	40.6	31.3	27.7
EBITDA	29.6	38.7	29.5	24.2
Operating profit	26.8	38.3	29.4	24.9
PBT	24.0	40.8	28.8	24.7
HSBC EPS	21.1	42.6	26.9	23.6
Ratios (%)				
Revenue/IC (x)	3.8	3.1	2.9	3.0
ROIC	82.8	68.2	62.3	61.1
ROE	64.3	58.7	51.3	44.3
ROA	40.8	35.2	31.2	27.9
EBITDA margin	27.9	27.5	27.1	26.4
Operating profit margin	25.8	25.4	25.0	24.4
EBITDA/net interest (x)				
Net debt/equity	-5.0	-5.7	-20.2	-27.4
Net debt/EBITDA (x)	-0.1	-0.1	-0.4	-0.6
Per share data (INR)				
EPS reported (fully diluted)	29.71	42.36	53.77	66.47
HSBC EPS (fully diluted)	29.71	42.36	53.77	66.47
DPS	6.75	12.00	15.00	18.00
NAV	59.69	84.69	125.02	174.87

Valuation data

	03/2006a	03/2007e	03/2008e	03/2009e
EV/sales	9.2	6.6	4.9	3.7
EV/EBITDA	33.1	23.8	18.0	14.2
EV/IC	27.4	16.3	13.0	9.8
PE*	42.5	29.8	23.5	19.0
P/NAV	21.1	14.9	10.1	7.2
FCF yield (%)	1.3	1.2	2.9	3.1
Dividend yield (%)	0.5	1.0	1.2	1.4

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

Price relative



Source: HSBC

Note: price at close of 13 Apr 2007

March 07 results summary: Revenues at INR51.4bn (+6%q-o-q, +38%y-o-y) were in line with our lower than consensus estimate. However, EBIT at INR13.2bn (+4%q-o-q, +47%y-o-y) and EBIT margins at 25.6% (-48bps q-o-q, +152bps y-o-y) were lower than our estimates. Net profit at INR 11.7bn (+6%q-o-q, +47%yoy) was lower than our estimate despite significantly higher other income (+200%q-o-q) due to gains from sale of Sitel stake.

TCS: Trends in quarterly profit and loss (INRm, %)

	4Q06	3Q07	4Q07	% qoq	% yoy	Comments
Revenue	37,234	48,605	51,464	6%	38%	Vol(+6.4%); Px (1.3%); Fx(-1.87%)
Cost of revenues	20,477	26,506	28,144	6%	37%	
Gross profit	16,757	22,099	23,320	6%	39%	Expect offshore salary +12-15% hikes
Gross margin (%)	45.0%	45.5%	45.3%	-15bps	31bps	and onsite 3-5% in FY08
SG&A	7,792	9,427	10,147	8%	30%	
% of sales	20.9	19.4	19.7	32bps	-121bps	
EBITDA	9,830	13,752	14,568	6%	48%	
EBITDA margin (%)	26.4%	28.3%	28.3%	1bps	191bps	
Depreciation	865	1080	1395	29%	61%	
Operating income	8,965	12,673	13,173	4%	47%	Mgmt has guided at stable margin in FY08
Operating margin (%)	24.1%	26.1%	25.6%	-48bps	152bps	
Other income	(40)	300	898	199%	nm	Includes gain from sales of Sitel stake
PBT	8,925	12,972	14,071	8%	58%	
Income tax	(898)	(1,828)	(2,188)	20%	144%	
Effective Tax rate	10.1%	14.1%	15.6%	146bps	549bps	to remain stable in FY08
Income before minorities	8,027	11,144	11,882	7%	48%	
Minority interests	(103)	(115)	(158)	38%	54%	
Equity in Affiliates	33	17	4	-79%	-89%	
Net income from ops	7,958	11,047	11,728	6%	47%	
Net margin (%)	21.4%	22.7%	22.8%	6bps	142bps	
FD EPS (INR)	8.1	11.3	12.0	6%	47%	

Source: Company, HSBC

Other highlights: TCS plans to give 12-15%y-o-y wage hikes for offshore and 3-5%y-o-y for onsite employees. Management reiterated that business outlook remains strong with increasing demand outlook for its offshore services. TCS closed c12 USD50m+ deals during the quarter and declared a quarterly dividend of INR4. Gross employee additions for FY08 are likely to be higher than 32,000.

Comparison of TCS and Infosys for March 07 quarter (INRm)

	TCS	%qoq	%yoy	Infosys	%qoq	%yoy
Revenues	51,464	6.0%	38.0%	37,720	3.20%	43.80%
Gross margins (%)	45.30%	-15bps	31bps	46.40%	-60bps	+60bps
EBITDA	14,568	6.0%	48.0%	11,970	0.10%	43.70%
EBITDA margin (%)	28.30%	1bps	191bps	31.70%	-100bps	0bps
EBIT	13,173	4.0%	47.0%	10,520	-0.30%	52.70%
EBIT margin (%)	25.60%	-48bps	152bps	27.90%	-100bps	160bps
PAT	11,728	6.0%	47.0%	10,200	3.60%	51.30%
Net margin (%)	22.80%	6bps	142bps	27.00%	10bps	140bps

Source: Company, HSBC

Valuation

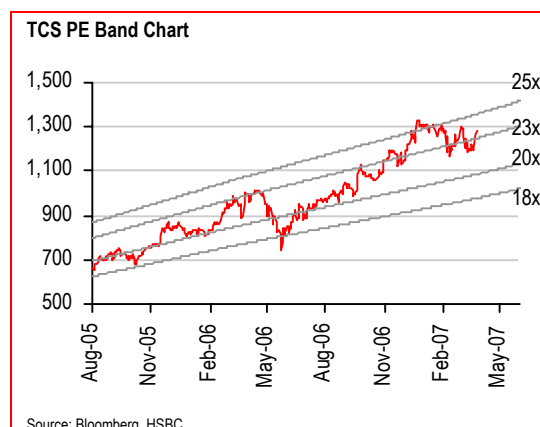
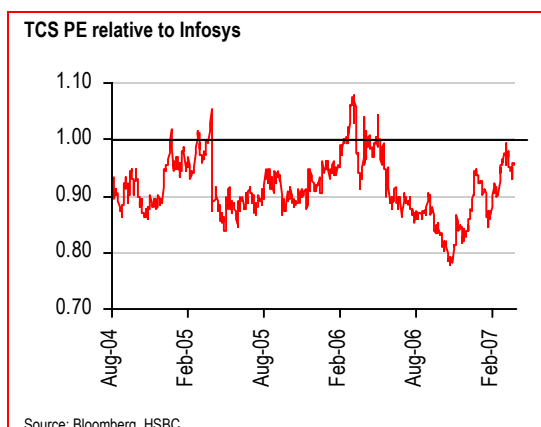
We rate TCS Overweight with a target price of INR1,600, based on a higher one-year rolling forward PE of 24x.. Our target PE was derived by an analysis of the historical trading patterns of the stock and its historical discount range to Infosys. Over the last year, TCS has largely traded at a discount to Infosys, with a maximum of 0-15%, and at an average of 5% over the last two years. At the current stage of TCS's growth phase, we believe the stock should trade at the higher end of its historical trading range, and hence

we apply an in line multiple with our Infosys valuations for our target price. Given that the potential total return to our target exceeds the Neutral band under our ratings model, we reiterate our Overweight rating.

Risks

Key risk factors, in our view, are:

- (1) Given its focus on inorganic growth, acquisition and execution-related risks are the primary risks for TCS
- (2) Any slowdown in or uncertainty about IT spend in the US, which is the largest market for Indian IT services companies
- (3) Any significant appreciation of the rupee vis-à-vis the dollar could be detrimental to margins of IT services companies
- (4) Country risks, terrorist attacks, and geopolitical risks may impact projects
- (5) TCS's limited disclosures, despite one of the strongest industry processes, is a cause for concern, in our view
- (6) Risks associated with government policies as any significant change in government policy over the tax holiday to offshore IT services vendors in India could significantly impact the profitability for TCS



Disclosure appendix

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Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

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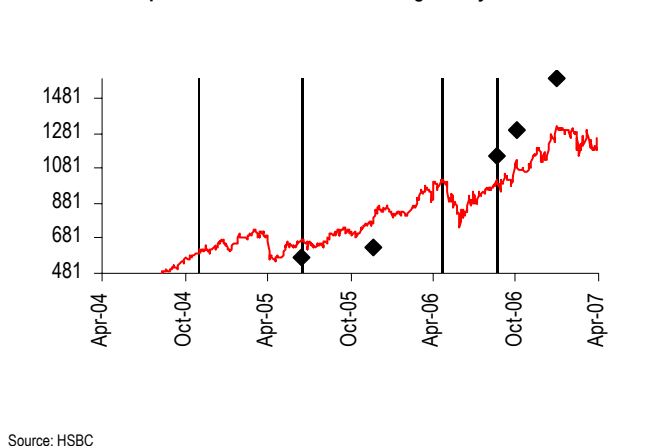
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Share price and rating changes for long-term investment opportunities

TCS Share Price performance INR Vs HSBC rating history



Recommendation & price target history

From	To	Date
N/A	N/R	15 November 2004
N/R	Underweight	30 June 2005
Underweight	N/A	05 May 2006
N/A	Overweight	04 September 2006
Target Price	Value	Date
Price 1	N/R	15 November 2004
Price 2	575.00	30 June 2005
Price 3	625.00	07 December 2005
Price 4	1160.00	04 September 2006
Price 5	1300.00	16 October 2006
Price 6	1600.00	16 January 2007

Source: HSBC

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Issuer of report

HSBC Securities and Capital Markets (India) Private Limited

Registered Office

52/60 Mahatma Gandhi Road

Fort, Mumbai 400 001, India

Telephone: +91 22 2267 4921

Fax: +91 22 2263 1983

Website: www.hsbcnet.com/research

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