Tata Consultancy Services Ltd.

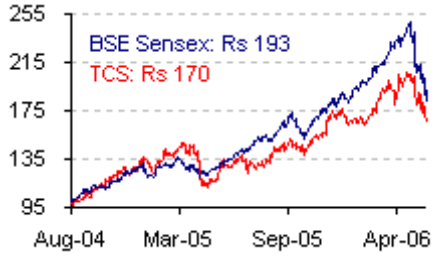
Buy **Target price: Rs 2,215**

Market data

Current price	Rs 1,671 (BSE)
Market cap	Rs 817,629 m
Face value (Re)	1.0
FY06 Div/share	13.50
NSE symbol	TCS
No of shares	489.3 m
Free float	16.3 %
52 week H/L	Rs 2,092 / 1,215

Share price chart

Rs 100 invested is worth



Shareholding

Category	(%)
Promoters	83.7
Banks, FIs, MFs	3.3
FIIs	7.2
Public	4.8
Others	1.0
Total	100.0

Report prepared by

Quantum Information Services
www.equitymaster.com
info@equitymaster.com

Investment Rationale

- **Move to 'full-service' capabilities:** TCS has made numerous strategic moves in recent times in order to enhance and broaden its array of service offerings, with a long-term objective to become a 'full service capability' organisation. In this respect, FY06 was a landmark year for the company. It acquired an Australian company called FNS – a banking software product company. It also acquired Comicrom, a Chilean insurance and pensions BPO company. Apart from this, the company, in what is a landmark deal for the Indian IT-BPO industry, won a £ 486 m (US$ 850 m) deal from the UK-based Pearl Group to process its insurance policies through a proprietary platform. Apart from these moves, the company also merged a group company, Tata Infotech (TIL), with itself. All the above strategic initiatives will give TCS a broader portfolio of service offerings to go to the market with.

- **Increasing presence in high-growth areas:** TCS has incraesed its focus on high-end services, such as package implementation, enterprise solutions and solution frameworks (products). Its presence in the high-growth BPO business has also been enhanced in FY06, with the acquisition of Comicrom, a Chile-based BPO company specialising in insurance and pensions BPO. The landmark Pearl deal win has resulted in a big business opportunity in platform-based BPO. While the order size is huge at US$ 850 m, the company is also looking to tap other business and process policies of other insurance companies in the UK through its proprietary platform.

  The proportion of these services in overall revenues has been increasing over the years. Nearly 30% of TCS' revenues come from enterprise solutions, products and consulting revenues. Also, a certain proportion of the application development and maintenance (ADM) revenues (71.5% of revenues in FY06) are turnkey, end-to-end software development services, which are of relatively high importance for the clients. While TCS does not give these figures separately, it is reasonable to assume that the total proportion of revenues from high-end services would be similar to that of peers like Infosys, which derive over 35% of revenues from high-end services. Going forward, we expect the percentage of these revenues to increase, as TCS focuses on high-growth areas, such as products, enterprise solutions, infrastructure management services, consulting, engineering services and BPO.

- **Management quality:** Like Infosys and Wipro, management quality is one of the strongest reasons to buy TCS. The management has been instrumental in transforming TCS into the largest software company not just in India, but also in Asia. The company has grown its revenues and profits at a CAGR of 34% and 30% respectively during FY01 to FY06. This compares well with Infosys' revenue and profit figures of 38% and 31% respectively. Going forward, we expect the company to continue to maintain a healthy pace of growth and

record a CAGR of 28% and 25% for its revenues and profits respectively during FY06 to FY09.

- **The offshoring opportunity:** Global IT and BPO spending was estimated at around US$ 1 trillion in 2005 as per the NASSCOM-McKinsey Report 2005. India's software services exports were at US$ 17.2 bn in FY05, as per NASSCOM figures, and the numbers are expected to top US$ 22.3 bn in FY06. Thus, India has a mere 3% share of the global market. Further, the total offshoring potential is estimated at US$ 330 bn, while the actual amount offshored is a mere US$ 30 bn. This clearly underscores the enormous scope for growth. Given increasing acceptance of offshoring by global corporations and also by companies in Europe, traditionally conservative and a late adopter of offshoring, the future appears strong. We expect the top-tier companies like TCS to be among the major beneficiaries of the offshoring story, given the company's scalability, proven execution skills and long-term relationships formed with marquee clients like GE, which give it annual business in excess of US$ 250 m.

Comparative Valuations

(FY06)	TCS	Infosys	Wipro
Operating ratios			
Sales CAGR (FY02-FY06, %)	31.9	38.3	32.5
EBDITA margin (FY06, %)	27.7	32.5	23.9
Profits CAGR (FY02-FY06, %)	27.1	32.1	23.6
Net profit margin	21.8	25.8	19.5
Rev / employee (Rs m)	2.4	2.1	2.2
Return ratios			
Return on equity (%)	63.8	40.0	34.8
Return on assets (%)	39.8	29.8	24.9
Asset turnover (x)	1.5	1.0	1.1
Valuations			
Price (Rs)	1,671	2,795	436
Price to earnings (x)	28.4	31.9	30.1
Price to sales (x)	6.2	8.2	5.9
EV/EBDITA (x)	22.1	24.3	24.2

Investment Concerns

- **Managing growth:** TCS has an employee base of nearly 66,500 people. Going forward, given increasing competition for scarce talent, a constant need to scale up and hence recruit in larger numbers and an ever-growing base, managing growth and employees will prove to be a non-too-easy task for the company. The software industry does not enjoy the benefits of operating leverage like a manufacturing company does, but faces all the disadvantages of it. For example, any software services company will have to recruit a greater number of employees in order to fulfill orders and bring the benefits to the topline and bottomline. It is not like a manufacturing company, where a certain number of employees and a certain scale will result in operating leverage, with increased volumes contributing directly to the bottomline of the company with the same number of employees after recovery of associated fixed costs. However, during a downturn, as in the case of a manufacturing company, employees on the bench will still have to be paid, regardless of whether they are working on projects or not. Thus, as the employee base increases, if a downturn does strike, the company will be affected adversely.

- **Short-term adverse margin impact:** Due to TCS' recent acquisitions, such as FNS and Comicrom, and the merger of TIL, the company's operating margins will take a hit in the short-term, as it starts to integrate these acquisitions with itself. Given that all the companies acquired and merged have considerably lower margins than TCS, that the impact on margins will be negative is a no-brainer. Nonetheless, we believe that this is just a short-term negative, and that over the long-term, TCS will be able to effectively use these acquisitions to get 'full service capabilities' and reduce the pace of margin decline.

- **Decreasing cost advantage:** In the software services business, Indian companies traditionally have had a cost advantage over their Western competitors in markets like the US and Europe. However, the downturn in the US economy in 2001 and 2002 forced MNC players to set up base in India and replicate the business models of Indian companies. This has threatened the Indian IT industry's cost leadership. Indian companies have also been made to face intense competition for talent. All these pressures mean stagnant billing rates and higher employee costs going forward. We expect TCS' cost of revenues to rise from the current levels by FY09. In line with the industry,

this will affect the company's margins and, consequently, the profitability going forward.

Background

TCS is the largest software services company in Asia, ahead of other Indian software service providers like Infosys and Wipro. The company has a wide range of offerings and caters to industries like banking, insurance and financial services (41% of FY06 revenues), manufacturing (17%), telecom, (15%) and retail (7%). TCS was one of the pioneers of the much-acclaimed global delivery model and the same has helped it to post good results in the past. The company's revenues and profits have grown at CAGR of 34% and 30% respectively over the period FY01 to FY06.

TCS has the largest employee base in the Indian software sector, with nearly 66,500 employees, and this highlights the fact that the company has managed to build significant scale in its business. Also, with a high onsite presence, TCS works closely with its clients and this has helped the company in building up long-term relationships with some key customers. For instance, the company has over 20 year relationships each with the GE Group and State Farm Insurance.

Industry Prospects

Global technology spending seems to be on an up-trend, with the offshore component seeing impressive traction, driven by increasing acceptance of the 'global delivery model'. However, the demand seems to be shifting from low-end services to high-end ones, like IT consulting, package implementation and systems integration. While Indian software companies are increasingly facing competition from global MNCs who are replicating the Indian offshoring model, the need of the hour for the Indian companies is to rapidly move up the software value chain. Increasingly, the demand for technology is likely to be more guided by the 'Return on Investment' factor, i.e., how much of cost saving or return on investment can be obtained by clients from their IT spending. As such, Indian IT companies that provide a broad range of services and have proven capabilities in executing large and complex projects are likely to emerge winners over the long term.

Risk Analysis

Sector: The Indian software industry is in the 'growth phase', with the top-tier players growing at a rate of over 25% annually. Offshoring as a concept is witnessing increased acceptance, leading to a strong accretion to the order books of software majors, resulting in impressive growth for these companies. Going forward, this is expected to continue over the medium-to-long term as well. However, increasing competition from MNC software companies, who are themselves setting up their offshore delivery networks, and most importantly, higher attrition rates and employee costs, are the major headwinds facing the top-tier Indian software incumbents. Based on these factors, we have assigned the stock a medium-risk rating of 5.

Sales: TCS generated average revenues to the tune of nearly Rs 80 bn (US$ 1.8 bn) each year over the last five years. Further, in the latest financial year (FY06), the company generated Rs 132.4 bn in sales (just under US$ 3 bn). We, thus, assign a low-risk rating of 10 to the stock.

Current ratio: We have taken the last four years' data for the purpose of calculating this ratio. TCS' average current ratio during the period FY03 to FY06 has been 1.8 times. This indicates that the company has a reasonably comfortable ability to pay off its short-term obligations. Further, this ratio has actually increased over the past two years. We assign a medium-risk rating of 6.

Debt to equity ratio: A highly leveraged business is the first to get hit during times of economic downturn, as companies have to consistently pay interest costs, despite lower profitability. We believe that a debt to equity ratio of greater than 1 is a high-risk proposition. Considering, TCS' average debt to equity ratio of just 0.02 over the past four fiscals, we have assigned a low-risk rating of 10 to the stock.

Long term EPS growth: We expect TCS' net profit to grow at a compounded rate of around 25% over the period FY06-FY09 (growth of 30% during FY01-FY06). Based on a normal scenario, we consider a compounded growth of over 20% in net profits in the last 5 years as healthy for a company. As such, the rating assigned to the stock on this factor is 8.

Dividend payout: A stable dividend history inspires confidence in the management's intentions of rewarding shareholders. Given the fact that TCS was listed only in August 2004, we have taken the last 2 fiscals (FY05 and FY06) for the purpose of calculating the payout ration. TCS' average payout ratio was a healthy 24% in these 2 fiscals. Thus, we have assigned a medium-risk rating of 6.

Promoter holding: A larger share of promoter holding indicates the confidence of the people who run it. We believe that a greater than 40% promoter holding indicates safety for retail investors. At the end of March 2006, the promoter holding in TCS stood at 83.7%, which is healthy. We have assigned a low-risk rating of 7 to the stock.

FII holding: We believe that FII holding of greater than 25% can lead to high volatility in the stock price. FII holding in TCS at the end of March 2006 stood at around 7.3%, which is comfortably within the limits. Therefore, the rating assigned is 8.

Liquidity: Given the fact that TCS was listed only in August 2004, we have taken the average daily trading volumes since listing. This figure is over 827,000 shares. This indicates that the TCS stock is highly liquid, and thus, the impact cost to acquire a large chunk will be relatively lower compared to other, more illiquid stocks. The rating assigned is 10.

Margin of safety: This is to determine the value of the stock relative to its price and the returns over a risk free rate. Margin of safety of a stock lies in its earning power, which is calculated as EPS / Market price (reciprocal of P/E). Considering TCS' P/E of 28.4 times its FY06 earnings, the earning power is 3.5%. Thus, the rating assigned is 4.

Considering the above parameters, the total ranking assigned to the company is 74. This makes the stock a low-risk investment from a long-term perspective.

Risk Matrix

	High Risk	Medium Risk	Low Risk
Rating	(1 to 3)	(4 to 6)	(7 to 10)
Sector	High	Medium	Low
Sales (US$ m)	< 500	501 - 1,000	> 1,000
Current Ratio (x)	< 1	1 - 2	> 2
Debt to equity ratio (x)	> 1	0.5 - 1	< 0.5
Long term EPS growth (%)	< 10	10 - 20	> 20
Dividend Payout (%)	< 15	15 - 25	> 25
Promoter holding (%)	< 25	25 – 40	> 40
FII holding (%)	> 25	10 - 25	< 10
Liquidity (Nos. '000)	< 100	100 - 200	> 200
Margin of Safety (%)	< 3	3 - 6	> 6
Final Rating	**< 30**	**30 – 60**	**> 60**

Valuations

The stock currently trades at Rs 1,671 implying a price to earnings multiple of 18.1 times our estimated FY08 earnings. Considering the fact that offshoring as a concept is gaining increasing acceptance, the company's move to 'full-service capabilities', its scalability, top quality management and premier positioning amongst the top offshore service providers, we expect the company to clock superior topline and bottomline growth over the long-term. We, thus, recommend a 'Re-iterate Buy' on the stock with a revised target price of Rs 2,215 from an FY08 perspective.

Valuation table

(Rs m)	FY05UA	FY06E	FY07E	FY08E
Revenue	97,272	127,772	161,507	203,989
PAT	20,521	29,006	34,771	41,848
EPS (Rs)	42.7	60.4	72.4	87.2
P/E (x)	29.9	21.1	17.6	14.7
Mkt cap/Sales (x)	6.3	4.8	3.8	3.0

Performance over the years…

	FY05	FY06
Promoter holding (%)	84.8	83.7
Net sales (Rs m)	97,272	132,455
EBDITA margin (%)	29.3%	27.7%
Net profit (Rs m)	20,521	28,831
Net margin (%)	21.1%	21.8%
Debt to equity (x)	0.1	0.0
Return on networth (%)	70.6%	63.8%
Dividend per share (Rs)	11.5	13.5

Financials at a glance

(Rs m)	FY06	FY07E	FY08E	FY09E
Sales	132,455	171,989	219,207	277,879
Sales growth (%)	*36.2%*	*29.8%*	*27.5%*	*26.8%*
Operating profit	36,748	46,609	59,186	73,360
Operating profit margin (%)	*27.7%*	*27.1%*	*27.0%*	*26.4%*
Net profit	28,831	36,106	45,144	55,823
Net profit margin (%)	*21.8%*	*21.0%*	*20.6%*	*20.1%*
Balance Sheet				
Current assets	49,600	82,179	123,593	177,023
Fixed assets	15,072	19,717	24,365	28,842
Investments	7,086	7,086	7,086	7,086
Goodwill	4,630	3,086	1,543	-
Other assets	9,239	9,239	9,239	9,239
Total Assets	**85,626**	**121,306**	**165,826**	**222,190**
Current liabilities	23,706	31,056	39,636	50,658
Net worth	58,408	86,378	121,862	166,644
Minority interest, other liabilities	3,513	3,873	4,328	4,888
Total liabilities	**85,626**	**121,306**	**165,826**	**222,190**

Sector Statistics

Sales (Rs m)		Market cap. (Rs m)		EBDITA margin (%)		Net profit margin (%)		Return on NW (%)	
Accenture*	17,094	Accenture	25,934	Infosys	32.5%	Infosys	25.8%	TCS	63.8%
TCS	2,969	TCS	18,170	TCS	27.7%	TCS	21.8%	Accenture	59.3%
Wipro***	2,356	Infosys	17,441	Wipro	23.9%	Wipro	19.5%	Infosys	40.0%
Infosys	2,151	Wipro	13,835	Accenture	12.3%	Accenture	5.5%	Wipro	34.8%

* US-based technology major, ** Conversion rate at US$ 1 = Rs 45, *** Consolidated numbers,
**** All figures taken are FY06/CY05 numbers.

Important Notice: Quantum Information Services Pvt. Limited (Equitymaster) is an Independent Equity Research Company.

Disclosure: The author of this article does not hold shares in the recommended company. QIS does not hold shares in the recommended company.