

Tata Consultancy Services

STOCK INFO.	BLOOMBERG
BSE SENSEX: 10,007	TCS IN
	REUTERS CODE
S&P CNX: 2,933	TCS.BO

19 July 2006

Buy

Previous Recommendation: Buy

Rs1,758

	YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
	END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
Equity Shares (m)	489.4										
52-Week Range	2,099/1,241										
1,6,12 Rel. Perf. (%)	5/1/-3										
M.Cap. (Rs b)	860.3										
M.Cap. (US\$ b)	18.4										
	3/06A	132,550	28,968	59.2	20.3	29.7	14.7	62.1	69.9	6.4	23.0
	3/07E	179,970	38,364	78.4	32.4	22.4	9.8	51.2	58.2	4.7	17.7
	3/08E	222,388	46,370	94.8	20.9	18.6	7.0	42.9	50.0	3.7	14.1

- TCS reported 11.3% QoQ growth in revenues to Rs41.44b v/s our expectation of Rs40.28b in 1QFY07. This is due to higher than expected volume growth at 8.1% and higher revenue from Pearl Deal (BPO). Pricing continued to remain stable during the quarter, with improvement in new and renegotiated contracts.
- The company added 62 clients during the quarter and graduated additional 11 existing clients to >US\$10m revenue bracket. TCS recruited 4,710 (net) employees and attrition rates increased to 10.6% from 9.9% in 4QFY06. Utilization rates improved to 77.3% from 75.8% in 4QFY06.
- EBITDA margins declined 220bp due to salary hikes, visa costs, integration of low margin Pearl BPO deal and infrastructure ramp ups for large deals.
- Higher than expected other income at Rs668m (due to forex gain of over Rs400m) and lower than expected tax rate led to 8.5% QoQ in net profit to Rs8.6b against our estimate of Rs8.2b.
- Following the strong demand forecast and higher than expected profit growth in 1QFY07, we have revised our estimates for FY07 and FY08 upwards. Our EPS estimates have been revised upwards to Rs78.4 and Rs94.8 from Rs75.7 and Rs93.1 in FY07 and FY08 respectively. At CMP, the stock is trading at a P/E of 18.6x FY08E. Maintain **Buy** with a price target of Rs2,180.

QUARTERLY PERFORMANCE

(Rs Million)

Y/E MARCH	FY06				FY07				FY06*	FY07E*
	1Q	2Q	3Q*	4Q*	1Q*	2QE*	3QE*	4QE*		
Revenues	27,094	29,513	34,527	37,234	41,443	43,871	46,260	48,396	132,550	179,970
Q-o-Q Change (%)	4.8	8.9	17.0	7.8	11.3	5.9	5.4	4.6	36.3	35.8
Direct Expenses	13,621	15,428	18,064	19,897	23,071	24,074	24,899	25,680	69,746	97,724
Sales, General & Admin. Expenses	5,515	5,573	6,696	7,507	8,356	8,555	8,743	9,147	25,797	34,801
Operating Profit	7,958	8,513	9,767	9,830	10,016	11,242	12,618	13,569	37,008	47,445
Margins (%)	29.4	28.8	28.3	26.4	24.2	25.6	27.3	28.0	27.9	26.4
Other Income	98	170	-154	-40	668	100	300	100	257	1,168
Depreciation	540	592	738	865	751	834	971	1,065	2,806	3,621
PBT bef. Extra-ordinary	7,517	8,091	8,875	8,919	9,932	10,509	11,947	12,604	34,459	44,992
Provision for Tax	1,247	1,317	1,319	898	1,238	1,524	1,732	1,828	4,984	6,321
Rate (%)	16.6	16.3	14.9	10.1	12.5	14.5	14.5	14.5	14.5	14.0
Minority Interest	83	43	45	70	69	73	79	86	280	306
Net Income bef. Extra-ordinary	6,187	6,731	7,511	7,951	8,626	8,912	10,136	10,691	29,211	38,364
Q-o-Q Change (%)	9.0	8.8	11.6	5.9	8.5	3.3	13.7	5.5	29.6	31.3
PAT aft Extra-ordinary	6,187	6,731	7,511	7,725	8,626	8,912	10,136	10,691	28,968	38,364

*Consolidated numbers that include Tata Infotech

Strong volume growth drives up revenue for the quarter

TCS reported 11.3% QoQ growth in revenues to Rs41.44b vs. our expectation of Rs40.28b in 1QFY07. This is due to higher than expected volume growth at 8.1% and higher revenue from Pearl Deal (BPO). Pricing continued to remain stable during the quarter, with improvement in new and renegotiated contracts to the extent of 3%-4%.

New services contribution on the increase, even as ADM increases due to higher discretionary spending

New service lines such as Consulting, Business intelligence and assurance services for some of the large clients also contributed to growth. ADM services grew 10.7%QoQ due to increase in development work on the back of increase in discretionary spending. However, the overall contribution of ADM to revenue declined to 68.9% in 1QFY07 from 69.3% in 4QFY06 (71.5% in FY06 and 72.9% in FY05). This was due to increase in contribution from high margin businesses – Enterprise solutions grew 14.9%QoQ.

REVENUE BY SERVICE OFFERING (RS M)

	JUN-05	SEP-05	DEC-05	MAR-06	JUN-06
ADM	19,508	20,748	24,998	25,803	28,554
Contribution %	72.0	70.3	72.4	69.3	68.9
Growth % QoQ	4.1	6.4	20.5	3.2	10.7
Enterprise soln and PI	5,879	6,906	7,734	9,122	10,485
Contribution %	21.7	23.4	22.4	24.5	25.3
Growth % QoQ	9.7	17.5	12.0	17.9	14.9
Asset leveraged soln	813	797	829	968	953
Contribution %	3.0	2.7	2.4	2.6	2.3
Growth % QoQ	0.8	-2.0	4.0	16.8	-1.5
Others	894	1,062	967	1,340	1,451
Contribution %	3.3	3.6	2.8	3.6	3.5
Growth % QoQ	-5.5	18.8	-9.0	38.7	8.2

Source: Company/ Motilal Oswal Securities

The company added 62 new clients during the quarter, including 23 in engineering services, 12 in infrastructure services, 6 in assurance services and 36 in the global consulting practice. The active client base increased to 764 from 748 in the previous quarter. Revenue from repeat business increased to 98.5% after falling to 91.9% in the previous quarter.

Top clients grew strongly during the quarter - the top client grew 20.3%, top 2-5 clients grew 6.3% and top 5-10 clients grew 10.5%QoQ. GE as a percentage of revenue declined to 9% from 10.3% during the quarter, it declined 2.7% QoQ in absolute terms.

TOP CLIENT GROWTH (%)

	JUN-05	SEP-05	DEC-05	MAR-06	JUN-06
Top Client	2.0	26.4	-25.4	7.8	20.3
Top 2-5	-2.0	-6.8	37.7	7.8	6.3
Top 10	0.4	4.5	15.4	7.4	8.5
Top 10 (Excl. Top 5)	2.5	13.7	0.2	7.0	10.5
Non Top 10	6.8	10.8	17.6	8.0	12.4

Source: Company/ Motilal Oswal Securities

Client mining seems to be paying off with effective transition of clients to higher revenues. The number of client with revenue >US\$10m increased from 54 to 65 in 1QFY07, while another client was added to the >US\$50m list.

CLIENT MIX (NOS)

	JUN-05	SEP-05	DEC-05	MAR-06	JUN-06
Clients>US\$1m	219	233	243	256	258
Clients>US\$5m	79	84	87	96	97
Clients>US\$10m	45	50	55	54	65
Clients>US\$50m	5	5	6	9	10

Source: Company/ Motilal Oswal Securities

Campus offers at 8,710

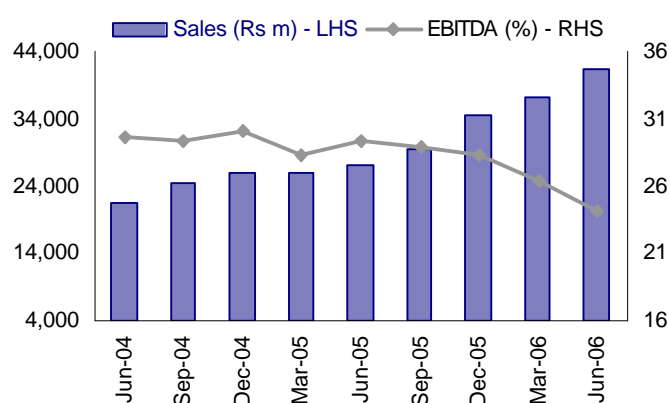
The company added 4,710 employees during the quarter, taking total employee base to 71,190. The gross addition was higher at 7,095 due to increase in attrition rates to 10.6% from 9.9% in the previous quarter. TCS visited 180 campuses during the quarter out of an anticipated 300 campus visits in FY07. 8,710 have been made so far and we expect to total offers on campus to touch 15,000 by the end of the year.

Higher wage costs depress margins by 230bp

TCS had salary hikes of 3-4% onsite and 15% offshore effective April 2006, which impacted gross margins by 111bp. The company had higher infrastructure set up cost during the quarter due to ramp up in large deals, which impacted margins further. Additionally the company

integrated Pearl BPO during the quarter, which resulted in higher foreign salary costs. Consequently, gross margins were down 230bp during the quarter. SG&A expenses stayed flat during the quarter. EBITDA margins declined 230bp on account of the reasons discussed earlier.

EBITDA MARGIN DECLINE DURING THE QUARTER



Source: Company/ Motilal Oswal Securities

Forex gain of Rs400m props up profits

TCS had a forex gain of Rs400m during the quarter, which resulted in higher than expected other income at Rs668m. Tax rate during the quarter was lower than expected at 12.5% (as against 14.5% expected), which led to 8.5% QoQ in net profit to Rs8.6b against our estimate of Rs8.2b.

Volume growth to remain robust with improvement in margins

The management continues to remain confident about the strong demand scenario and the robustness of the revenue pipeline for the year. We expect this to translate to a healthy volume growth of more than 35% in FY07, with the integration of Pearl and ramp up in big deals adding to the pace of growth. The management has bagged several big deals during the year, the chief of them being the US\$500m 5-year deal with Citigroup.

Margins, which have declined sharply over the past few quarters, are expected to revive in the coming quarters due to the presence of significant margin levers.

Offshore composition is currently at a low 38.1% (50.9%

for Infosys, 46.6% for Wipro); Tata Infotech offers scope for transition of work offshore, which could improve margins. The management had earlier stated that it hopes to increase offshore composition by 1% every quarter, which seems optimistic. However, any improvement in offshore composition would be beneficial to margins.

- Large deals that were initiated during FY06 would start coming out of knowledge transfer phase, which would lead to improvement in margins.
- Composition of employees with <3 years of experience, which is currently at 50%, could move up further, leading to flattening of employee pyramid. This would reduce overall cost per employee for the company. The company has in the past indicated that it would be comfortable with a 55% composition of employees with <3 years of experience, which offers sufficient headroom for improvement.
- The management hopes to achieve reduction in SG&A expenses over the next few quarters, which would also ease margin pressures. We believe this will be possible with improvement in offshore revenue contribution.
- TCS has acquired several companies in over the last few quarters, which are in various stages of integration. With full integration, the company hopes to achieve synergies that would improve margins in the acquired entities and overall margins for the company.

For the FY07 the company is targeting at maintaining its full year OPM margins at FY06 levels of 27.9% which we believe is optimistic.

Outlook and view

Following the strong demand forecast and higher than expected profit growth in 1QFY07, we have revised our estimates for FY07 and FY08 upwards. We now expect TCS to record revenue growth of 35.8% and 23.6% in FY07E and FY08E respectively, with profit growth of 32.4% and 20.9% in the same period. Our EPS estimates have been revised upwards to Rs78.4 and Rs94.8 from Rs75.7 and Rs93.1 in FY07 and FY08 respectively. At CMP, the stock is trading at a P/E of 18.6x. Maintain **Buy** with a price target of Rs2,180.

Tata Consultancy Services: an investment profile

Company description

TCS is the largest IT services company in India, with revenue of US\$2.9b in FY06. It employs more than 70,000 people, and provides IT as well as BPO services to more than 750 clients. It is the preferred vendor for a majority of the Fortune 500/Global 1,000 companies. Its top clients include GE, Prudential, AIG, Target, P&O Nedlloyd, ABN Amro and Standard Chartered.

Key investment arguments

- ☞ Experience of handling multi-million dollar contracts places it suitably against global players.
- ☞ Client diversification, leading to narrowing gap in growth differential compared to peers.
- ☞ Has considerable near shore presence, could give a competitive edge to peers in bagging clients who are new to offshoring.

Key investment risks

- ☞ Most vulnerable to salary inflation, as average salary per employee is lower compared to peers.
- ☞ Lowering of experience profile could impact quality, as TCS is used to delivering services with lateral people.
- ☞ Inclination to accept large complete IT outsourcing deals could impact profitability and return ratios.

Recent developments

- ☞ Won a large deal from a major BFSI customer, valued at US\$500m for application maintenance and support, to be executed over five years
- ☞ Completed integration Pearl BPO with itself and created a new subsidiary Diligenta.

Valuation and view

- ☞ Revenue CAGR of 29.5% and EPS CAGR of 26.5% over FY06-08.
- ☞ Valuations at 18.6x FY08E earnings attractive, given strong growth and likely revenues of more than US\$4.5b in FY08.
- ☞ Maintain **Buy** with a target price of Rs2,180.

Sector view

- ☞ Various CIO surveys indicate increasing share of offshore spending in IT budgets
- ☞ Indian offshore vendors gaining market share in competition with MNCs
- ☞ Prefer large companies, as bulk of volumes going to them; niche players benefit due to lack of offshore competition

COMPARATIVE VALUATIONS

		TCS	INFOSYS	WIPRO
P/E (x)	FY07E	22.4	25.4	23.9
	FY08E	18.6	21.1	19.8
P/BV (x)	FY07E	9.8	9.3	6.6
	FY08E	7.0	6.9	5.3
EV/Sales (x)	FY07E	4.7	6.3	4.2
	FY08E	3.7	4.8	3.3
EV/EBITDA (x)	FY07E	17.7	19.7	17.8
	FY08E	14.1	15.4	13.9

SHAREHOLDING PATTERN (%)

	JUN.06	MAR.06	JUN.05
Promoters	83.7	83.9	84.8
Domestic Institutions	3.3	2.8	2.5
FII's/FDIs	7.5	7.9	6.3
Others	5.6	5.4	6.4

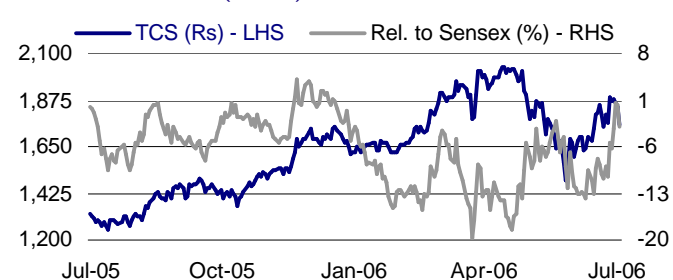
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	78.4	77.3	1.4
FY08	94.8	95.3	-0.5

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
1,759	2,180	24.0	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2004	2005	2006	2007E	2008E
Sales	71,227	97,272	132,550	179,970	222,388
Change (%)	29.1	36.6	36.3	35.8	23.6
Cost of Services	37,706	51,105	69,746	97,724	123,530
EBITDA	19,578	28,505	37,008	47,445	58,161
% of Net Sales	27.5	29.3	27.9	26.4	26.2
Depreciation	1,331	1,577	2,806	3,621	4,330
Interest	0	0	0	0	0
Other Income	988	757	257	1,168	1,100
PBT	19,234	27,685	34,459	44,992	54,932
Tax	2,899	4,065	4,984	6,321	8,240
Rate (%)	15.1	14.7	14.5	14.0	15.0
Equity in net earnings of affilii	160	18	16	65	150
PAT	16,495	23,638	29,491	38,736	46,842
Minority Interest	125	79	280	371	472
Extraordinary	0	-3,038	-243	0	0
Net Income	16,369	20,521	28,968	38,364	46,370
Change (%)	52.6	25.4	41.2	32.4	20.9

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2004	2005	2006	2007E	2008E
Share Capital	364	480	489	489	489
Share Premium	0	0	0	0	0
Reserves	16,114	31,497	57,919	87,459	123,164
Net Worth	16,479	31,977	58,408	87,948	123,653
Minority Interest	1,268	1,323	1,564	1,935	2,407
Loans	7,490	1,928	979	0	0
Capital Employed	25,687	35,712	62,900	91,832	128,009
Gross Block	12,574	15,261	20,535	40,535	60,535
Less : Depreciation	3,853	5,360	8,166	11,787	16,117
Net Block	8,721	9,902	12,369	28,748	44,418
CWIP	220	968	2,703	3,001	3,501
Other LT Assets	3,074	3,164	13,868	14,690	16,413
Investments	310	4,183	7,086	15,000	25,000
Curr. Assets	22,472	30,692	49,600	62,391	84,091
Debtors	13,838	20,343	32,790	41,171	47,785
Cash & Bank Balance	1,566	2,633	3,965	6,710	17,236
Loans & Advances	0	0	0	0	0
Other Current Assets	7,068	7,717	12,845	14,510	19,071
Current Liab. & Prov	9,110	13,197	22,726	31,998	45,416
Creditors	1,909	2,727	4,308	5,553	6,632
Other liabilities	7,202	10,469	18,418	26,444	38,781
Net Current Assets	13,362	17,495	26,874	30,393	38,675
Application of Funds	25,687	35,712	62,900	91,832	128,008

E: MOST Estimates

RATIOS					
Y/E MARCH	2004	2005	2006	2007E	2008E
Basic (Rs)					
EPS	34.2	49.2	59.2	78.4	94.8
Cash EPS	36.2	45.2	64.9	85.8	103.6
Book Value	33.7	65.4	119.4	179.7	252.7
DPS	0.0	8.4	13.5	18.0	21.8
Payout %(Incl.Div.Taxes)	0.0	20.0	22.8	23.0	23.0
Valuation (x)					
P/E		35.7	29.7	22.4	18.6
Cash P/E		38.9	27.1	20.5	17.0
EV/EBITDA		30.0	23.0	17.7	14.1
EV/Sales		8.8	6.4	4.7	3.7
Price/Book Value		26.9	14.7	9.8	7.0
Dividend Yield (%)		0.5	0.8	1.0	1.2
Profitability Ratios (%)					
RoE	102.0	80.4	62.1	51.2	42.9
RoCE	80.8	90.2	69.9	58.2	50.0
Turnover Ratios					
Debtors (Days)	71	76	90	83	78
Fixed Asset Turnover (x)	5.7	6.4	6.5	4.4	3.7
Leverage Ratio					
Debt/Equity Ratio(x)	0.5	0.1	0.0	0.0	0.0

CASH FLOW STATEMENT					
(Rs Million)					
Y/E MARCH	2004	2005	2006	2007E	2008E
CF from Operations	17,896	24,046	31,953	47,384	57,371
Cash for Working Capital	-1,978	-3,772	-7,098	-4,611	-2,518
Net Operating CF	15,918	20,274	24,855	42,773	54,853
Net Purchase of FA	-2,889	-3,909	-12,511	-21,119	-22,223
Net Purchase of Invest.	157	-2,033	-2,074	-7,914	-10,000
Net Cash from Invest.	-2,732	-5,942	-14,585	-29,033	-32,223
Proceeds from Pvt. Place.	55	18,921	71	0	0
Proceeds from LTB/STB	290	-5,563	-1,193	-979	0
Net Cash withdrawn by Tata	-13,275	-23,000	0	0	0
Dividend Payments	-33	-3,624	-7,960	-10,015	-12,105
Cash Flow from Fin.	-12,964	-13,265	-9,083	-10,994	-12,105
Free Cash Flow	13,029	16,365	12,344	21,653	32,630
Net Cash Flow	222	1,067	1,187	2,745	10,526
Opening Cash Balance	1,343	1,566	2,778	3,965	6,710
Add: Net Cash	222	1,067	1,187	2,745	10,526
Closing Cash Balance	1,566	2,633	3,965	6,710	17,236



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1. Analyst ownership of the stock
2. Group/Directors ownership of the stock
3. Broking relationship with company covered
4. Investment Banking relationship with company covered

Tata Consultancy Services

No
 No
 No
 No

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