

TATA CONSULTANCY SERVICES



Picture perfect

Tata Consultancy Services (TCS) could not have delivered a better quarter than this one, every time superseding the earlier threshold. Q2FY11 has been an almost perfect quarter with no blemishes. **"Profitable growth"** has been the key theme that TCS delivers from this strong set of numbers, coming on top of an already strong Q1FY11. The company has fired on all cylinders simultaneously - handsome revenue and margin performance, volume growth of 11% Q-o-Q, eight large deal wins spread across sectors, highest ever organic gross/net employee addition of 19,293/10,717, sequential growth of 10% plus across verticals & most clients, and most importantly, EBITDA margin improvement by 70bps to 30% (historic high).

Revising up EPS estimates; initial signs of next year budget seen up

We see upgrade in consensus EPS numbers for TCS, despite the appreciating INR. We are revising up our EPS by 4% for FY11 and 6% for FY12 to INR 42.6 and INR 48.4, respectively. Also, the CEO remarked about the likely increase in IT budgets for the next fiscal based on preliminary discussions with a small set of clients. **"Growth agenda"** and **"being efficient"** are key themes driving the IT spending at client organizations in the current environment.

Closing margin gap to Infosys; EBIT difference now only 220bps

We see that the most impressive part of TCS' performance over the past 4-6 quarters is its ability to rigorously close the margin gap with Infosys. TCS' EBIT margin has expanded over 300bps since the start of the last fiscal. At the same time, we see advantages such as market diversity (horizontals), geographic diversity, end-to-end service offerings, and ability to bag large, bundled deals among others playing in harmony currently.

Outlook and valuations: Firing on all cylinders; maintain 'BUY'

At CMP of INR 986, the stock is trading at a P/E of 23.2x and 20.4x for FY11E and FY12E earnings, respectively. With consistent outperformance on revenues (Q-o-Q) and strong margins, we see TCS' valuations improving further and possibly entering the premium zone to that of Infosys. We maintain **'BUY'** on the stock and rate it **'Sector Outperformer'** on relative returns.

October 21, 2010

Reuters: TCS.BO Bloomberg: TCS IN

EDELWEISS 4D RATINGS

Absolute Rating	BUY
Rating Relative to Sector	Outperformer
Risk Rating Relative to Sector	Low
Sector Relative to Market	Equalweight

Note:
Please refer last page of the report for rating explanation

MARKET DATA

CMP	:	INR 986
52-week range (INR)	:	1,011 / 593
Share in issue (mn)	:	1,957.2
M cap (INR bn/USD mn)	:	1,930 /43,504
Avg. Daily Vol. BSE/NSE ('000):	:	2,057.2

SHARE HOLDING PATTERN (%)

Promoters*	:	74.0
MFs, FIs & Banks	:	8.1
FIIIs	:	12.4
Others	:	5.4
* Promoters pledged shares (% of share in issue)	:	11.3

PRICE PERFORMANCE (%)

	Stock	Nifty EW Technology Index
1 month	5.6	0.0
3 months	16.7	11.4
12 months	59.3	17.0

Financials

(INR mn)

Year to March	Q2FY11	Q1FY11	% Chg	Q2FY10	% Chg	FY10	FY11E
Net revenues	92,864	82,173	13.0	74,351	24.9	300,289	371,688
EBITDA	27,894	24,088	15.8	21,342	30.7	86,799	108,772
Reported net profit	21,065	18,442	14.2	16,238	29.7	68,737	83,417
Diluted EPS (INR)	10.8	9.4	14.2	8.3	29.7	35.1	42.6
Diluted P/E (x)						28.1	23.2
EV/EBITDA (x)						21.8	17.2
EV/Revenues (x)						6.3	5.0

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- **Key highlights**

- Revenues, at INR 92.9 bn, jumped 13.0% Q-o-Q and 25% Y-o-Y. In USD terms, revenues grew 11.7% to USD 2,004 mn. In constant currency terms, the company delivered 11% sequential growth.

Table 1: Split of revenue growth in INR terms for Q2FY11

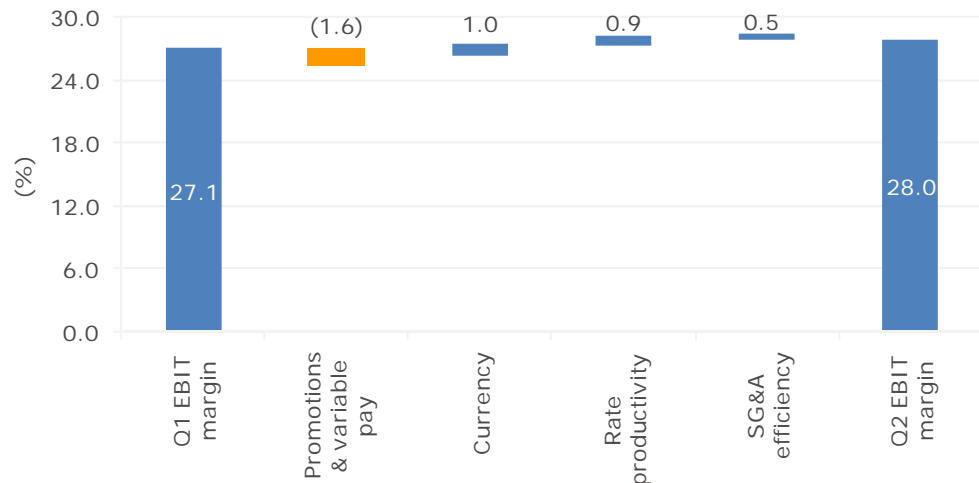
Revenue growth break-up	(%)
Volumes	11.2
Exchange	2.0
Pricing	(0.3)
Q-o-Q impact	13.0

Source: Company

- Gross profit for the quarter stood at INR 43.4 bn, up 13.7% Q-o-Q. Gross margin was flat at 46.8%.

Operating margin improves further: The Company's operating margin (EBIT) increased further by 86bps Q-o-Q and now stands at 28.0%

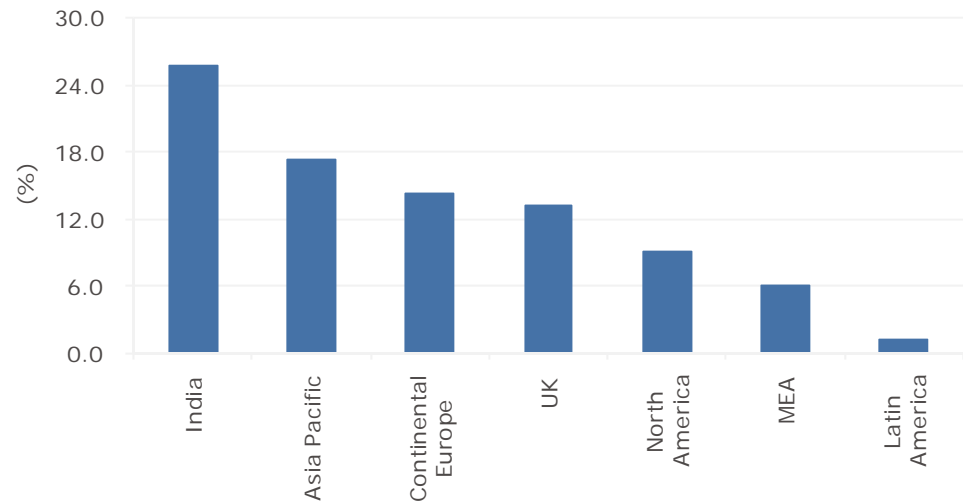
Chart 1: Factors contributing to increase in operating margins (EBIT margins)



Source: Company

- **Net income:** TCS reported net income of INR 21.1 bn, up 14.2% Q-o-Q. Net profit margin now stands at 22.7% versus 22.4% in the previous quarter.
- **Continued traction in large deals:** The company won 8 large deals during the current quarter in addition to 10 in the previous quarter, compared to 9 deals by Infosys in H1.
- **Growth robust across geographies:** India led the growth with 25.7% sequential growth in USD terms. Continental Europe too saw a turnaround with 14.2% Q-o-Q growth after lackluster performance for the past two quarters.

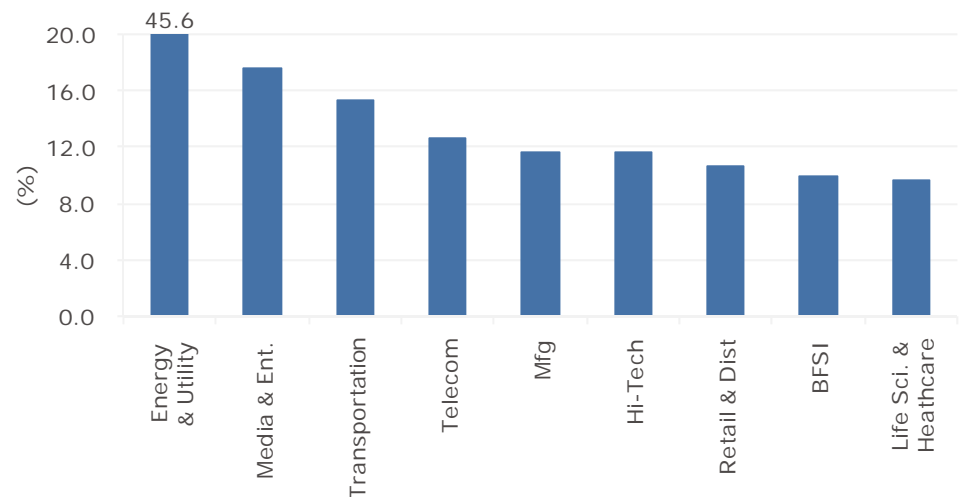
Chart 2: India, APAC and Europe led the growth for the quarter



Source: Company, Edelweiss research

- All-round performance across verticals:** All the verticals have reported a double-digit sequential growth. This is second consecutive quarter where all the verticals have reported Q-o-Q growth. Key to note is that even manufacturing has shown a strong growth of 11.7% Q-o-Q in USD terms.

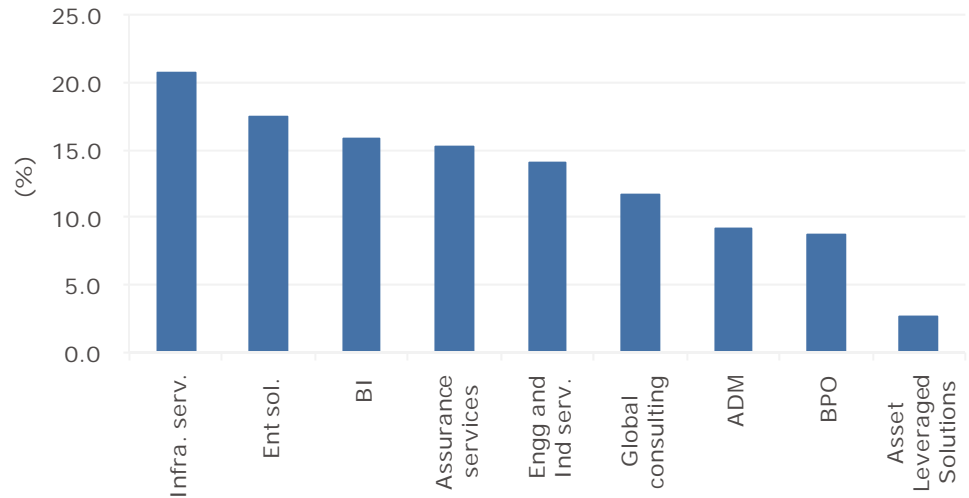
Chart 3: Six verticals posted close to 12% sequential growth



Source: Company, Edelweiss research

- **Broad based growth across service lines:** Growth momentum across horizontals continued with all showing sequential growth. Four verticals namely business intelligence, enterprise solutions, assurance services and infrastructure services reported more than 15% Q-o-Q growth.

Chart 4: Four horizontals posted more than 15% sequential growth



Source: Company, Edelweiss research

- **Client metrics:** TCS added 30 new clients (36 in Q1) during the quarter versus 27 for Infosys. The active clients count stood at 936 versus 930 in the previous quarter. The number of USD 1 mn clients increased by 11 to 420; there was an increase in USD 5 mn (1), USD 10 mn (9), USD 20 mn (1), USD 50 mn (1) and USD 100 mn (1) client bracket, over the previous quarter.
- **Hiring momentum continues:** Gross addition of 19,293 was the highest ever, while net addition was 10,717, partly on account of attrition. Total headcount stands at 174,417.
- Utilisation rate (excluding trainees) rose 120bps and now stands at 83.8%; including trainees, it increased 290bps to 77.7%.
- Offshore revenue contribution was flat at 51%.

Financial snapshot**(INR mn)**

Year to March	Q2FY11	Q1FY11	% Change	Q2FY10	% Change	FY10	FY11E	FY12E
Net revenues	92,864	82,173	13.0	74,351	24.9	300,289	371,688	442,365
Cost of revenue	49,448	43,978	12.4	39,215	26.1	157,244	198,195	236,037
Gross profit	43,416	38,195	13.7	35,136	23.6	143,045	173,493	206,328
SG&A	15,277	13,880	10.1	13,693	11.6	55,395	63,374	76,087
R&d	244	227	7.4	101	141.3	851	1,346	1,548
EBITDA	27,894	24,088	15.8	21,342	30.7	86,799	108,772	128,693
Depreciation & amortization	1,886	1,781	5.9	1,811	4.1	7,208	7,797	9,290
EBIT	26,008	22,307	16.6	19,531	33.2	79,591	100,976	119,403
Other income	337	834	(59.6)	(144)	(333.7)	2,256	3,411	3,792
Profit before tax	26,345	23,141	13.8	19,386	35.9	81,847	104,386	123,195
Tax	4,992	4,423	12.9	2,909	71.6	12,089	19,846	27,103
Core profit	21,353	18,718	14.1	16,478	29.6	69,758	84,541	96,092
Minority interest	(289)	(272)	NA	(240)	NA	(1,019)	(1,121)	(961)
Share in equity investment	-	(3)	(100.0)	-	-	(2)	(3)	-
Reported net profit	21,065	18,442	14.2	16,238	29.7	68,737	83,417	95,131
Diluted EPS (INR)	10.8	9.4	14.2	8.3	29.7	35.1	42.6	48.4

As % of net revenues

Gross profit	46.8	46.5		47.3		47.6	46.7	46.6
SG&A	16.5	16.9		18.4		18.4	17.1	17.2
R&d	0.5	0.5		0.3		0.5	0.7	0.7
EBITDA	30.0	29.3		28.7		28.9	29.3	27.0
Adjusted net profit	23.0	22.8		22.2		23.2	22.7	21.7
Reported net profit	22.7	22.4		21.8		22.9	22.4	21.5
Tax rate	18.9	19.1		15.0		14.8	19.0	22.0

- **Company Description**

TCS is India's largest and one of its oldest IT companies. It commenced operations in 1968 and provides a comprehensive range of IT services to industries such as banking and financial services, insurance, manufacturing, telecommunications, retail, and transportation. With a presence in 42 countries, TCS is positioned to deliver its services seamlessly. TCS has a large diversified client base (930 active clients), which include seven Fortune Top-10 companies. TCS' employee force stands at 174,417 (including subsidiaries) and its revenues for the last twelve months (TTM) stood at INR 329 bn (USD 7.1 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. It is a serious contender for winning large deals, as it has more experience than peers in implementing large, complex, and 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. End-to-end full services offerings, traction in emerging markets, ability to roll up large acquisitions, improving sales and marketing prowess and willingness to take multiple big bets (different go-to-market models) are among the key rationales for TCS to sustain its long term hi-growth trajectory.

- **Key Risks**

Key risks to our investment theme include – double dip recession in major market US and prolonged slowdown in Europe, sharp cross currency movements and appreciation of rupee against USD, Euro and GBP and maintaining the margins, while pursuing large deals and while pricing pressures remain.

Financial Statements

Income statement					(INR mn)
Year to March	FY08	FY09	FY10	FY11E	FY12E
Net revenue	226,175	278,129	300,289	371,688	442,365
Cost of revenues	122,344	150,774	157,244	198,195	236,037
Gross profit	103,831	127,355	143,045	173,493	206,328
Total SG&A expenses	46,874	55,574	56,246	64,720	77,635
S&M expenses	46,309	55,143	55,395	63,374	76,087
G&A expenses	565	431	851	1,346	1,548
EBITDA	56,958	71,781	86,799	108,772	128,693
Depreciation & Amortization	5,745	5,766	7,208	7,797	9,290
EBIT	51,213	66,015	79,591	100,976	119,403
Other income	6,888	(4,673)	2,256	3,411	3,792
Profit before tax	58,101	61,342	81,847	104,386	123,195
Provision for tax	7,494	9,012	12,089	19,846	27,103
Core profit	50,607	52,330	69,758	84,541	96,092
Profit After Tax	50,607	52,330	69,758	84,541	96,092
Minority int. and others - paid/(recd.)	416	611	1,021	1,124	961
Profit after minority interest	50,190	51,720	68,737	83,417	95,131
Basic shares outstanding (mn)	1,958	1,957	1,957	1,959	1,967
Basic EPS (INR)	25.6	26.4	35.1	42.6	48.4
Diluted equity shares (mn)	1,958	1,958	1,957	1,959	1,967
Diluted EPS (INR)	25.6	26.4	35.1	42.6	48.4
CEPS (INR)	28.6	29.4	38.8	46.6	53.1
Dividend per share (INR)	7.0	7.0	20.0	8.5	10.0
Dividend (%)	699.8	703.6	2,000.0	850.0	1,000.0
Dividend payout (%)	32.0	31.2	66.4	23.3	24.1

Common size metrics					
Year to March	FY08	FY09	FY10	FY11E	FY12E
Cost of revenues	54.1	54.2	52.4	53.3	53.4
Gross margin	45.9	45.8	47.6	46.7	46.6
SG&A expenses	20.7	20.0	18.7	17.4	17.6
EBITDA margins	25.2	25.8	28.9	29.3	29.1
EBIT margins	22.6	23.7	26.5	27.2	27.0
Net profit margins	22.4	18.8	23.2	22.7	21.7

Growth ratios (%)					
Year to March	FY08	FY09	FY10	FY11E	FY12E
Revenues	21.4	23.0	8.0	23.8	19.0
EBITDA	12.5	26.0	20.9	25.3	18.3
EBIT	10.3	28.9	20.6	26.9	18.2
PBT	20.1	5.6	33.4	27.5	18.0
Net profit	21.4	3.4	33.3	21.2	13.7
EPS	21.5	3.0	32.9	21.2	13.6

Balance sheet**(INR mn)**

As on 31st March	FY08	FY09	FY10	FY11E	FY12E
Equity capital	979	979	1,957	1,959	1,967
Share premium account	24,372	24,372	23,401	23,401	23,401
Reserves & surplus	98,468	131,194	184,026	248,029	320,211
Shareholders funds	123,819	156,545	209,384	273,389	345,579
Minority interest (BS)	2,300	3,133	4,056	5,177	6,137
Borrowings	7,483	11,810	10,110	11,121	8,897
Sources of funds	133,602	171,487	223,549	289,686	360,613
Net block	30,214	37,490	41,706	56,410	62,120
Goodwill	14,738	34,185	32,415	32,415	32,415
Investments	26,503	17,271	37,816	45,376	54,448
Inventories	424	366	178	213	288
Sundry debtors	53,903	61,532	58,098	81,466	101,805
Unbilled revenue	13,525	14,814	12,011	13,692	15,609
Cash and equivalents	10,352	14,625	10,249	35,241	56,928
Prepaid & other current assets	14,965	31,666	59,584	65,543	81,929
Total current assets	93,169	123,003	140,120	196,155	256,558
Sundry creditors and others	33,949	44,395	43,651	58,929	67,768
Others current liabilities	371	5,158	34	38	30
Provisions	7,101	7,762	7,311	9,139	11,423
Total current liabilities & provisions	41,421	57,315	50,996	68,105	79,222
Net current assets	51,748	65,688	89,124	128,050	177,336
Uses of funds	133,602	171,487	223,549	289,686	360,613
Book value per share (INR)	63.2	80.0	107.0	139.5	175.7

Free cash flow**(INR mn)**

Year to March	FY08	FY09	FY10	FY11E	FY12E
Net profit	50,190	51,720	68,737	83,417	95,131
Depreciation	5,745	5,766	7,208	7,797	9,290
Others	(4,609)	(4,389)	(5,498)	(6,223)	(11,914)
Gross cash flow	51,326	53,097	70,447	84,990	92,507
Less: Changes in WC	12,280	(1,802)	(4,431)	13,938	27,592
Operating cash flow	39,046	54,899	74,878	71,053	64,915
Less: Capex	12,340	10,981	10,225	22,500	15,000
Free cash flow	26,706	43,917	64,653	48,553	49,915

Cash flow metrics

Year to March	FY08	FY09	FY10	FY11E	FY12E
Cash flow from operations	51,326	53,097	70,447	84,990	92,507
Cash for working capital	(12,280)	1,802	4,431	(13,938)	(27,592)
Operating cash flow	39,046	54,899	74,878	71,053	64,915
Net purchase of fixed assets	(12,340)	(10,981)	(10,225)	(22,500)	(15,000)
Net purchase of investments	(12,414)	11,523	(19,101)	(7,563)	(9,072)
Others in Cash Flow Metrics	(1,978)	(35,281)	(25,836)	3,411	3,792
Investing cash flow	(26,732)	(34,739)	(55,161)	(26,652)	(20,280)
Dividends	(14,953)	(16,121)	(19,594)	(19,419)	(22,939)
Proceeds from issue of equity	1,019	39	54	-	-
Redemption of Preferred Stock	(268)	(654)	(4,535)	3	(8)
Proceeds from LTB/STB	-	40	575	-	-
Financing cash flow	(14,202)	(16,696)	(23,500)	(19,416)	(22,947)
Exchange rate differences	(51.1)	810.3	(584.6)	-	-
Net cash flow	(1,888)	3,464	(3,783)	24,985	21,688

Profitability & efficiency ratios

Year to March	FY08	FY09	FY10	FY11E	FY12E
ROAE (%)	47.0	36.9	37.6	34.6	30.7
ROACE (%)	53.0	50.5	46.8	47.0	43.4
Debtors days	78	76	73	69	76
Payable days	47	51	54	50	52
Cash conversion cycle (days)	32	24	19	18	23
Current ratio	2.2	2.1	2.7	2.9	3.2

Operating ratios

Year to March	FY08	FY09	FY10	FY11E	FY12E
Total asset turnover	1.9	1.8	1.5	1.4	1.4
Fixed asset turnover	8.5	8.2	7.6	7.6	7.5
Equity turnover	2.1	2.0	1.6	1.5	1.4

Valuation parameters

Year to March	FY08	FY09	FY10	FY11E	FY12E
Diluted EPS (INR)	25.6	26.4	35.1	42.6	48.4
<i>Y-o-Y growth (%)</i>	<i>21.5</i>	<i>3.0</i>	<i>32.9</i>	<i>21.2</i>	<i>13.6</i>
CEPS (INR)	28.6	29.4	38.8	46.6	53.1
Diluted PE (x)	38.5	37.3	28.1	23.2	20.4
Price/BV (x)	15.6	12.3	9.2	7.1	5.6
EV/Sales (x)	8.4	6.9	6.3	5.0	4.2
EV/EBITDA (x)	33.4	26.7	21.8	17.2	14.3
EV/EBITDA (x) +1 yr forward	26.5	22.0	17.4	14.5	-
Dividend yield (%)	0.7	0.7	2.0	0.9	1.0



Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
HCL Technologies	HOLD	SP	H	Hexaware Technologies	BUY	SO	M
Info Edge	BUY	SO	M	Infosys Technologies	HOLD	SU	L
Infotech Enterprises	BUY	SO	H	Mphasis	REDUCE	SU	M
Patni Computer Systems	HOLD	SU	M	Tata Consultancy Services	BUY	SO	L
Wipro	BUY	SP	L				

ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
Sector Underperformer (SU)	Stock return < 1.25 x Sector return
	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return

Edelweiss
Ideas create, values protect



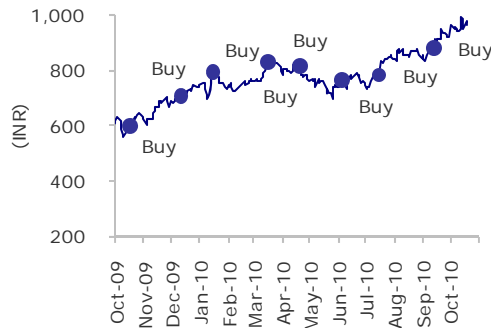
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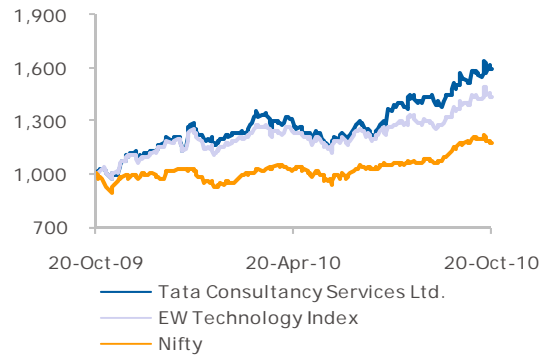
Coverage group(s) of stocks by primary analyst(s): IT

HCL Technologies, Hexaware Technologies, Infosys Technologies, Info Edge, Infotech Enterprises, Mphasis, Patni Computer Systems, Tata Consultancy Services, Wipro

Tata Consultancy Services



EW Indices



Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	116	45	12	176

* 3 stocks under review

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	110	53	13

Recent Research

Date	Company	Title	Price (INR)	Recos
20-Oct-10	HCL Technologies	Delivering revenue growth; Result Update	426	Hold
15-Oct-10	Infosys Technologies	Strong growth driven by onsite business; Result Update	3,076	Hold
14-Oct-10	Infotech Enterprises	Revenue growth accelerates, but margin blues remain; Result Update	175	Buy

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