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INDIA RESEARCH | IT SERVICES | BSE SENSEX: 16483 | 01 DECEMBER 2011

OUTPERFORMER

Tata Consultancy Services (TCS IN)

Management meeting note

Rs1,135

Mkt Cap: Rs2.2trn; US$43.2bn

We recently met the TCS management for an update on the business and outlook for CY12. TCS expressed confidence about the demand for IT services and said it did not see any red flags despite the challenging macro environment. The deal pipeline is healthy (similar to levels six months ago) and sales cycle/ client decision-making have not seen any delays. The pricing environment has also been stable, with COLA-based increases coming through. Operating margin is also expected to remain buoyant, with INR expected to remain weak and no supply side pressure. The management said that if the rupee weakness prolongs, it may plough back some gains into the business.

We expect the macro concerns to adversely impact CY12 IT budgets and, hence, growth rates of Indian IT services companies in FY13. However, we believe large players like TCS are better placed to weather the uncertainty due to stronger client relationships, scale and flexible cost structures. We incorporate currency changes in our financial estimates and raise FY12/13E EPS by 3-5% - we are now building Rs51/USD for H2FY12 and Rs49/USD for FY13. At Rs1,135, the stock trades at ~20x FY12E EPS and ~17x FY13E EPS. We rate TCS as Outperformer, with a 12-month price target of Rs1,290 (19x FY13E EPS) even as we retain our cautious stance on the sector.

Key financials

As on 31 March	FY10	FY11	FY12E	FY13E	FY14E
Net sales (Rs m)	300,289	373,245	498,753	589,223	660,040
Adj. net profit (Rs m)	68,895	87,164	111,726	132,581	148,779
Shares in issue (m)	1,958	1,957	1,957	1,957	1,957
Adj. EPS (Rs)	35.2	44.5	57.1	67.7	76.0
% change	*33.2*	*26.5*	*28.2*	*18.7*	*12.2*
PE (x)	32.2	25.5	19.9	16.8	14.9
Price/ Book (x)	10.6	8.7	6.6	5.1	4.0
EV/ EBITDA (x)	25.1	19.3	14.3	11.7	10.1
RoE (%)	37.7	37.6	37.8	34.2	29.8
RoCE (%)	40.4	42.5	45.1	40.9	35.5

Source: IDFC Securities Research

Demand: TCS sees no red flags yet

The management reiterated that the demand environment is healthy and that the larger players with deep client relationships have no cause for worry. Unlike concerns recently highlighted by a few peers, TCS said it has neither seen any instance of delayed decision-making nor any deferment in ramp-ups of deals won in the last 3-6 months. The management said the deal pipeline was healthy, similar to levels six months back. Decision-making on deal awards has also been along expected lines with no instances of unplanned ramp-downs or project cancellations, the company said. The pricing environment remains stable, with contractual COLA-based increases coming through. An increase beyond contractual hikes, however, looks difficult in the current environment, as per the management. Demand for IT services has been strong across verticals and geographies with an exception of Telecom vertical. We note that IT spend in telecom vertical has been weak since 2008 global financial crisis.

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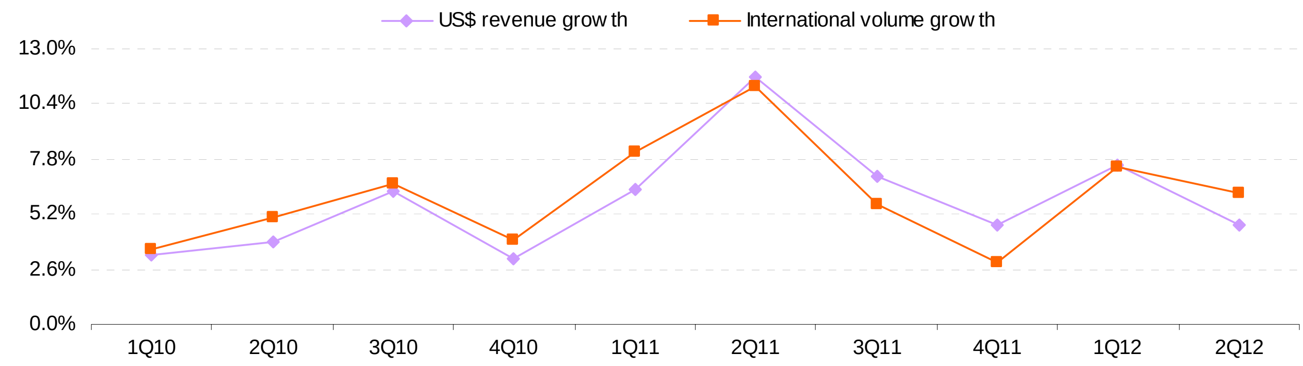
TCS does not see the benefit of the typical year-end budget flush this quarter as client spending has been on expected lines through the year. The lack of a budget flush and fewer working days in the Oct-Dec quarter are likely to lead to lower volume growth in Q3FY12. Growth in international business volumes is expected to moderate to 4-5% in Q3FY12 after a 6.2% sequential increase in Q2FY12. In the domestic business, revenue growth is lumpy and was weak during Q2FY12 – the management expects growth to recover in Q3FY12.

Exhibit 1: USD revenue growth and international volume growth for last 10 quarters

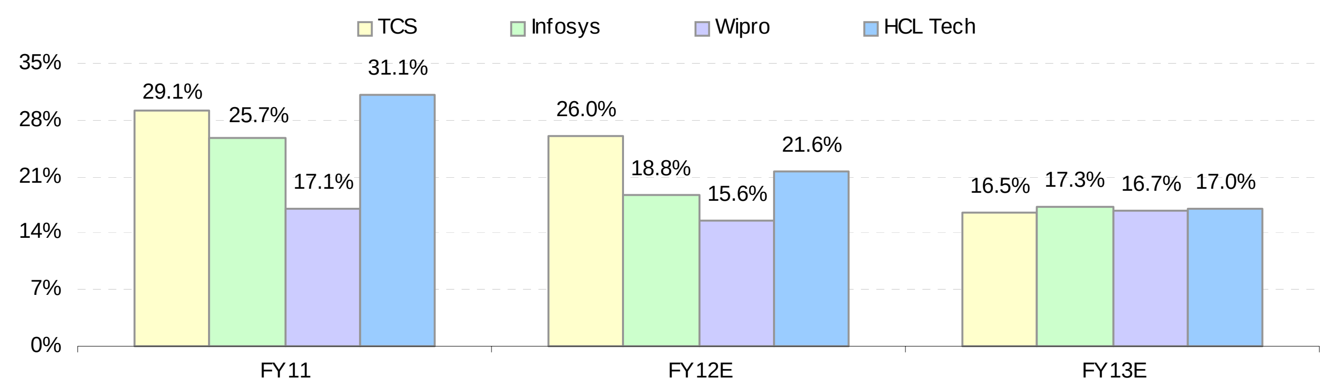


Source: Company

CY12 IT budgets likely to support 15-20% revenue growth

While it is still early days, the management believes IT budgets in CY12 could be in line with 2010/ 2011. Anecdotal evidence suggests budgets are likely to be 'ok' and a base-case growth of 15-20% in CY12/ FY13 is possible for TCS. The management believes that even a marginal increase in IT spend could drive 15-20% growth in revenues for the top Indian IT services companies. A case in point is the fact that despite just a 2-3% yoy increase in IT spend in CY10/ CY11 the top Indian IT services players clocked 25%+ revenue growth in FY11/ FY12.

Exhibit 2: Revenue growth for TCS, Infosys, Wipro and HCL Tech



Source: Company, IDFC Securities Research

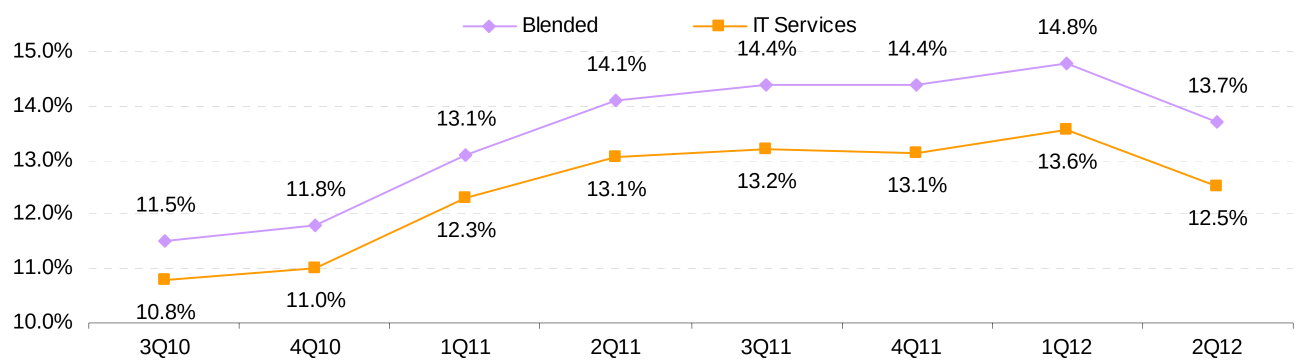
Margins likely to remain buoyant

The management does not foresee any major headwinds to margins in the near-to-medium term apart from annual wage hikes in April 2012. There has also been no pricing pressure despite the uncertain global macro-economic conditions – contractual COLA increases have helped price realizations, offset to an extent by cross-currency movements. The weakening rupee (~9% in Q3FY12 on daily average basis for quarter-till date) should help margins; but part of the benefits could be re-invested in the business (developing intellectual property, sales investment, etc.)

Supply side comfortable

TCS has made over 35,000 campus offers in FY12 and is on track to hire its target of 45,000 freshers next fiscal. Pent-up attrition is almost out of the system and reported attrition is likely to trend southward in the near term. The management said it was comfortable with the current utilization level (ex-trainees) of ~83%, which is unlikely to drop in the near term as hiring is based on demand at the SBU level.

Exhibit 3: TTM attrition trends in the past 8 quarters



Source: Company, IDFC Securities Research

Currency tailwinds

Benefits from ~9% depreciation of INR vis-à-vis USD during the quarter could be partly offset by cross-currency headwinds. We highlight that ~1% rupee depreciation would benefit TCS's EBIT margins by 30-35bp. The management also indicated that in the event of sustained weakness of the rupee, a part of the benefits could be re-invested in developing intellectual property or expanding into new geographies/ verticals.

Exhibit 4: INR has weakened sharply over last 4 months

Source: Bloomberg

Incorporating weaker INR in financial estimates

We raise FY12/13E earnings by 3-5% as we build in the weaker INR into our estimates – we are now incorporating Rs51/ 49 for H2FY12/ FY13, vs. Rs48/ 47 earlier. We have also accounted for cross currency headwinds in Q3FY12. We now expect ~26% USD revenue growth, largely flat margins, and 28% EPS growth in FY12. Our FY13/ FY14 estimates build ~17% USD revenue CAGR, flattish margins and 15% INR EPS CAGR over FY12-14E.

Exhibit 5: Earning revision table

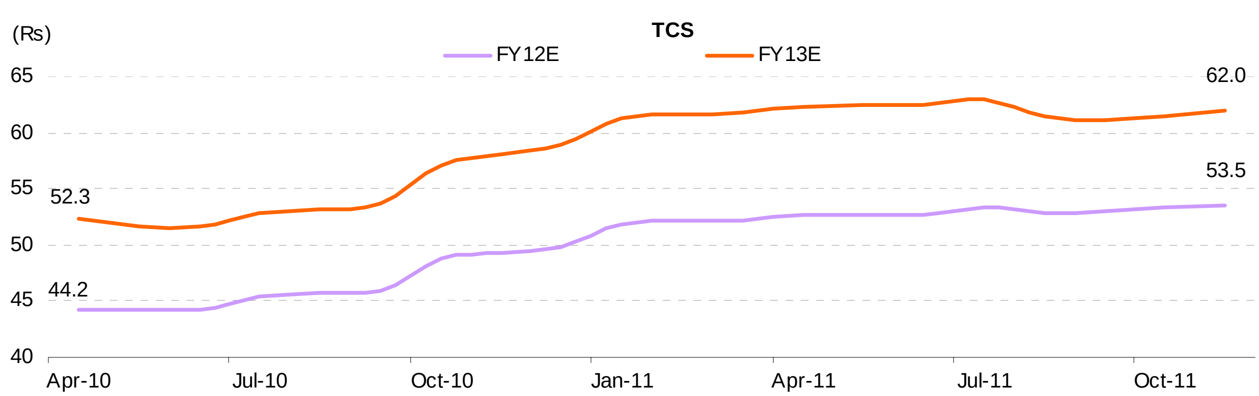
Year to 31-Mar	FY12E	FY13E	FY14E
Net income - Recurring			
- New	111,726	132,581	148,779
- Old	108,089	126,785	148,803
Change	*3.4%*	*4.6%*	*0.0%*
Recurring EPS - Fully diluted			
- New	57.1	67.7	76.0
- Old	55.2	64.8	76.0
Change	*3.4%*	*4.6%*	*0.0%*

Source: IDFC Securities Research

Valuations & view

The stock has outperformed the broader markets by ~15% YTD driven by an industry-leading financial performance. With the business surpassing expectations, Street earnings estimates for FY12/ 13 saw 8/ 5% upgrades during the period. Going forward, however, we do not see operational performance driving increases in Street or our earnings estimates. But, there could be upgrades if INR weakness persists.

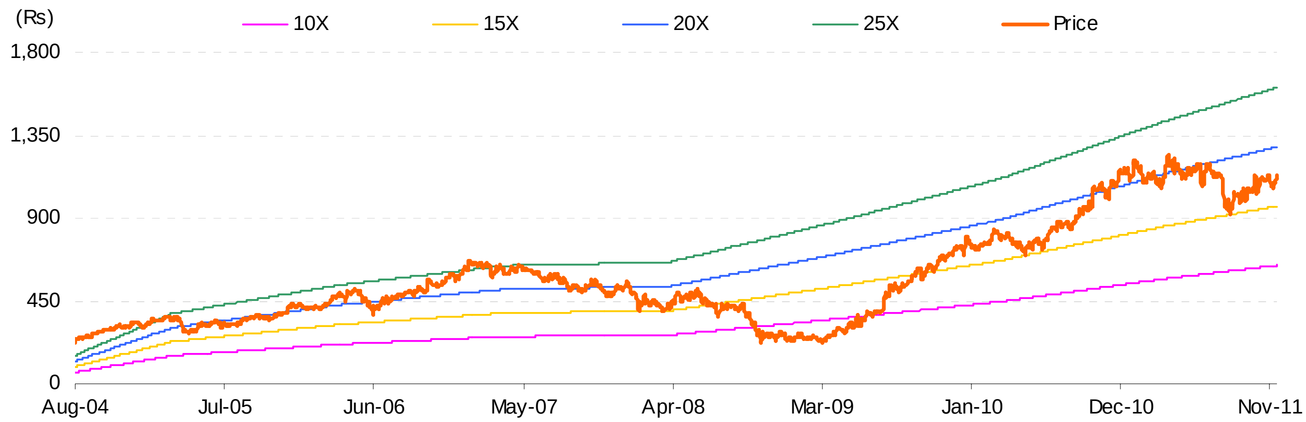
Exhibit 6: TCS – Street earnings upgrade cycle



Source: Company, Bloomberg, IDFC Securities Research

After the stock declined ~3% YTD, despite the 5-8% Street earnings upgrade, we believe the 12-month forward PER valuation of 17.7x (~20% lower than the business cycle mean) partly builds in the macro concerns. The stock is now trading at ~20x FY12E EPS and ~17x FY13E EPS. We continue to rate TCS as Outperformer and value it at a 12-month price target of Rs1,290, implying 19x FY13E EPS. TCS remains one of our only two Outperformer stocks in the IT services space (the other being Infosys). We remain underweight on the sector as we see FY13 growth rates vulnerable to likely muted IT budgets in CY12.

Exhibit 7: TCS – 12-month forward PER band chart



Source: Company, Bloomberg, IDFC Securities Research

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Explanation of Ratings:

1. Outperformer : More than 5% to Index
2. Neutral : Within 0-5% (upside or downside) to Index
3. Underperformer : Less than 5% to Index

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