

Landmark deal, but what about profitability?

First Look

Breaking news, market events and company announcements

November 11, 2011

Rating Remains	Neutral
Target price Remains	INR 1100
Closing price November 9, 2011	INR 1123

TCS reports US\$2.2bn deal win; second largest for the company

TCS has won a US\$2.2bn 15 year deal (US\$146mn per annum) from Friends Life UK. Under this deal, TCS would migrate existing Life and Pension policies of Friend's Life UK to its Diligenta platform. Diligenta would see an addition of ~3.2mn policies, taking the total to ~8mn live policies. This is a landmark deal in terms of size, and indicates traction for TCS' Diligenta Platform (which TCS acquired in 2005). Revenues from the deal should start accruing from Mar-2012 onwards and are expected to be largely evenly distributed over the term of the contract.

Profit margins likely to be very low, at least initially

We believe this deal would contribute very little to TCS's overall PAT level over the next 2-3 years, even though it would add ~1.5% in incremental revenues to TCS in FY13F. The reasons for likely low profitability are:

- About 1,900 employees, who we would expect to be largely UK based, would be transferred to TCS from Friends Life. The salary cost alone of these employees would be of the order of US\$90-100mn per year, assuming even median BPO salary costs in the UK.
- TCS would have to support duplicate platforms (Friends Life and Diligenta) until the migration is completed – which management expects to take 2-3 years. This would require additional cost to be incurred, in our view.

Diligenta platform business runs at ~ 3.5% PAT margin

TCS' current business from Diligenta and Diligenta 2 (acquired from Unisys) would have revenue of ~US\$200mn on an annualized basis and a PAT of ~US\$7mn (which translates to PAT margin of 3.5% vs company PAT margins of 23% in FY11F) on our estimates. These low levels of profit margin for existing business combined with the cost structure of the Friends Life business suggest to us that the Diligenta platform would continue to be margin dilutive, in our view, for at least the next 2-3 years. Although sentiment to the deal is likely positive, we see a neutral impact on the stock. Maintain Neutral with TP of INR1100.

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See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.

Fig. 1: Diligenta platform: Revenue and PAT trend

Diligenta platform which was acquired by TCS in 2005 took 4 years to break-even

Diligenta	FY06	FY07	FY08	FY09	FY10	FY11
Revenue (Rs mn)	488	6,369	5,626	5,269	4,562	5,812
Revenue (US\$ mn)	11	142	141	114	96	127
PBT (Rs mn)	3	-385	-349	-530	-789	233
PAT (Rs mn)	2	-270	-242	-409	-556	306
PAT margin (%)	0.5	-4.2	-4.3	-7.8	-12.2	5.3

Note: Data taken from TCS annual report. PAT margin and USD revenue are calculated.

Source: Company data, Nomura research

Fig. 2: Diligenta 2 business (acquired from Unisys): Revenue & PAT

Diligenta 2	FY11	FY11 Annualized
Revenue (Rs mn)	1,909	3,272
Revenue (US\$ mn)	42	72
PBT (Rs mn)	5.2	9
PAT (Rs mn)	5.2	9
PAT margin (%)	0.3	0.3

Note: Data taken from TCS annual report. PAT margin and USD revenue are calculated. The Diligenta 2 business was acquired on Aug 31, 2010. The FY11 annualized numbers are calculated by multiplying the FY11 numbers by 12/7.

Source: Company data, Nomura research

Fig. 3: Snapshot of existing and new Diligenta platform business

Annual run-rate	Diligenta + Diligenta 2	Friends Life
Revenues (US\$ mn)	199	147
PAT (US\$ mn)	7	
Policies (mn)	~5mn	3.2
Revenue per policy per annum(US\$)	40	46

Note: Revenue and annualized run-rate are Nomura estimates based on TCS annual report data.

Source: Company data, Nomura estimates

Appendix A-1

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Mentioned companies

Issuer name	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Tata Consultancy Services	TCS IN	INR 1123	09-Nov-2011	Neutral	Not rated	

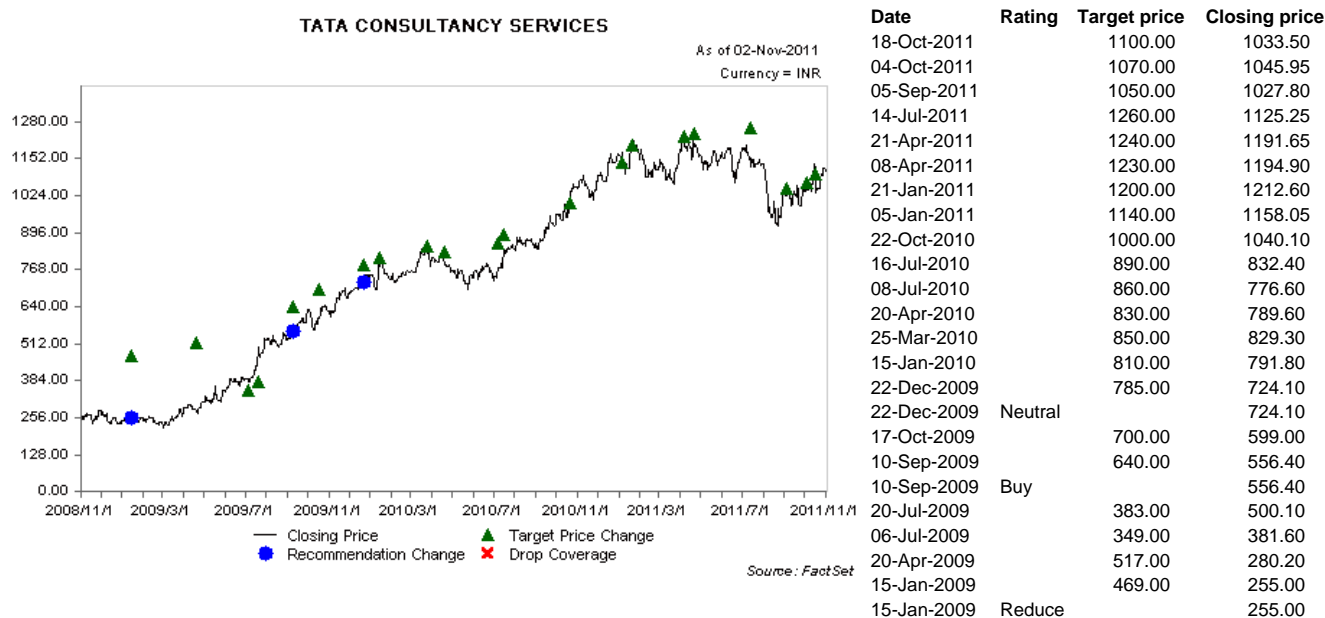
Previous Rating

Issuer name	Previous Rating	Date of change
Tata Consultancy Services	Buy	22-Dec-2009

Tata Consultancy Services (TCS IN)

INR 1123 (09-Nov-2011) Neutral (Sector rating: Not rated)

Rating and target price chart (three year history)



For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology Our target price of INR1,100 is based on 18x our FY13F earnings forecast of INR62. Our target multiple is in line with the stock's historical average, reflecting heightened economic uncertainties and risk on its high BFSI and Europe exposure.

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Explanation of Nomura's equity research rating system for Asian companies under coverage ex Japan published from 30 October 2008 and in Japan from 6 January 2009

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Explanation of Nomura's equity research rating system in Japan published prior to 6 January 2009

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