

Tata Consultancy Services (TCS)

Flawless execution, but perfectly priced

TCS' Q1FY13 results indicate flawless execution. The company has been able to report growth across most verticals in a tough environment. While revenue growth was in line with expectations, EBITDA margins were 100bp lower than our estimates and 50bp lower than consensus. While revenue growth has been broad based, we note that one mega deal won in November 2011 (effective March 2012) and one large telecom deal won last quarter contributed c.40% of incremental revenues in Q1FY13. Management commentary was positive indicating no change in stance v/s commentary of the past six months. We continue to believe that current valuation does not take into account client and vertical concentration risks. While we don't rule out a near term churn in favour of TCS from Infosys given consistent underperformance by the latter, we find it increasingly difficult to justify TCS' valuation. Reiterate Neutral.

Robust commentary lends comfort on numbers

In our recent initiation thematic, our key reason to remain Neutral on TCS was i) expensive valuation and two: ii) concentration risks within BFSI. While the valuation may remain expensive for an extended period of time given strong execution versus peers in a tricky environment, we don't think the current valuation appropriately accounts for client and vertical concentration risks.

- 1. Friend's Life and telco deal drove Q1 growth:** Over 30% of incremental revenues of \$80m in Q1FY13 came from the Friends Life deal (which largely explains why BFSI still looks strong - it accounts for \$25m of the \$50m incremental revenues in BFSI), and a little over 10% came from ramp-up in the telecom deal won last quarter. Our concern on concentration within BFSI remains and the top client has added just \$3m in incremental revenues and top 10 accounts have added only \$5m. TCS will need 3.8% CQGR over the next three quarters to achieve 14% growth in FY13 which could be tall ask given its high base.
- 2. Top client growth has moderated as expected:** TCS saw its revenues from its top client grow by 2% QoQ which was on expected lines. The top client grew 24% CAGR in the last three years boosted by spending on IT. However, those investments were completed in CY11 and growth going forward could be muted. With five BFS clients among the top 10 accounting for ~32-38% of BFS revenues (vs. 29-31% for Infosys), we believe client concentration risks are high. While peers have seen large scale ramp downs TCS has not. In the current environment we believe the possibility of such risks materializing is relatively high.
- 3. Margins expansion possibility limited:** Operating margins came in 100bps lower than expectations despite improvement in utilisation and favourable currency. The levers to improve margins are limited in our view. Firstly, price pressure will remain as Infosys has become aggressive on pricing and secondly, in the last two years, "other costs" have contributed to a 246 bps improvement in margins while all other costs have increased annually, which only indicates that TCS is operating at optimal margins with limited possibility to improve from here.

Valuation: 18.2x P/E multiple ignores risks

The current environment brings in significant demand volatility v/s earlier years. In such an environment with BFSI taking centre stage and TCS' exposure to the vertical being the highest among peers, the current valuation is not pricing in such risks. Moreover with growth rates among the top 10 clients reducing, risks to growth are only incrementally higher. We expect TCS to record 13% USD revenue growth in FY13 and earnings CAGR of 15% over FY12 to FY14. Stock trades at 18.2x FY13 earnings and we reiterate Neutral.

**FIT FOR
A NEW ERA**

Accounting & corporate governance	GREEN
Franchise Strength	GREEN
Earnings Momentum	GREEN

NEUTRAL

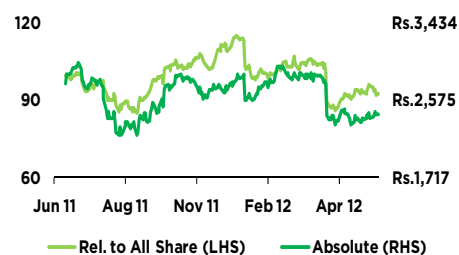
7% downside

Fair Value (Rs)	1,150
Bloomberg Code	TCS IN
Share Price (Rs)	1,233
Market Cap (Rs bn / \$ m)	\$44bn/Rs2,446bn
Free Float / FII holding	26% / 14%
ADV (Rs m/ \$m)	\$ 42m/Rs2.4bn

Rs m (unless stated) March YE	2011A	2012E	2013E	2014E
Total Income	373,246	488,938	617,111	671,912
EBITDA	112,100	144,177	180,834	196,083
PAT	86,296	105,471	132,464	140,454
EPS (Rs)	44.35	54.35	67.68	71.76
FCF	52,060	55,458	100,035	108,801

X (unless stated)	2011A	2012E	2013E	2014E
P/E	27.8	22.7	18.2	17.2
EV/Sales	6.3	4.7	3.6	3.3
EV/EBITDA	21.0	16.0	12.4	11.2
EV/EBIT	22.5	17.1	13.3	12.1

Figure 1 Historical share price performance



Source: Bloomberg

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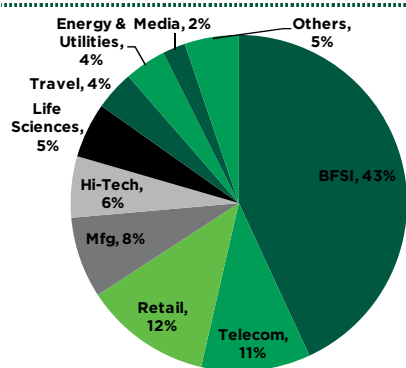
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Business model

Tata Consultancy Services (TCS), started in 1968, is the largest and oldest Indian IT services firm with revenues of over US\$10bn in FY12 and more than 238,500 employees. TCS offers a range of services: ADM, infrastructure management, consulting, enterprise solutions, testing and BPO. TCS' services customers in key verticals such as the banking, financial services and insurance, manufacturing, telecom, retail and distribution, energy and utilities, and life sciences verticals. Its main markets are the US (53% of FY10 revenue) and Europe (27%). TCS rejigged its organisation in April 2008. The new structure, defines the organization into five Industry Solutions Units (ISUs) – industry solutions group (ISG), major markets group (MMG), new growth market group (NMG), strategic initiative group (SIG) and organization infrastructure group (OIG).

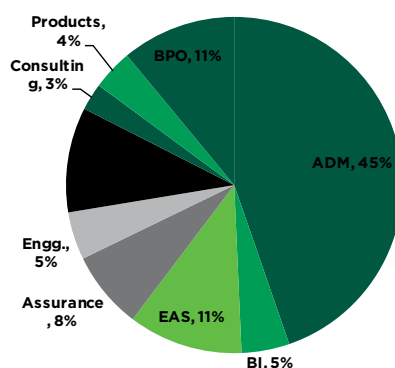
The ISG unit has multiple units dedicated to all the verticals that the company has presence in. All the existing clients will come under this group. Each unit under this will be of manageable size (which the company describes as having 2,500-5,000 people). The major markets' unit focuses on US, UK and Europe. The unit will be responsible for getting prospective and new client wins. The strategic initiative unit has three important units. First, is the TCS financial solutions unit, second, small and medium enterprises business solutions and finally, a new unit for platform BPO solutions. Finally, the organization infrastructure group will have four units, which will look into issues like process excellence, shared services group and resource management group.

Figure 2 Vertical wise revenue mix



Source: Company, Espirito Santo Investment Bank research

Figure 3 Horizontal wise revenue mix



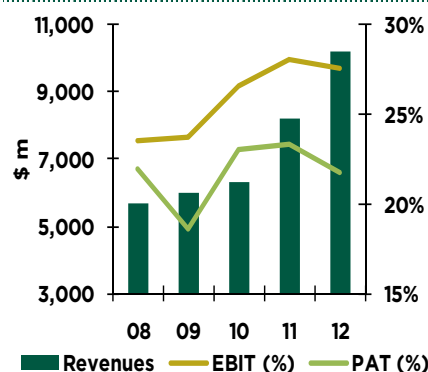
Source: Company, Espirito Santo Investment Bank research

Table 1 TCS Fact Sheet

	Number
Revenue FY12	\$10.2bn
Employees	238500+
Revenue per employee	\$42,767
Key Markets	
US	56% of sales
Europe	25% of sales
Asia Pacific	19% of sales
Key Segments	
Financial Services	43% of sales
Telecom	11% of sales
Total Clients	1,076
Top 10 client contrib.	27% of sales
\$100m + clients	14

Source: Company

Figure 4 Revenue, EBIT and PAT



Source: Company, Espirito Santo Investment Bank research

Key risk and sensitivities

Table 2 Scenario analysis

	High case	Base case	Low case
Price target	Rs.1,438	Rs.1,150	Rs. 925
Upside/downside:	15% upside	8% downside	26% downside
Assumptions	<ul style="list-style-type: none"> Revenue growth of 20% in next 3 years, followed by 14% for next 5 years and 10% for next 7 yrs Margin decline of 20 bps/ yr 	<ul style="list-style-type: none"> Revenue growth of 18% in next 3 years, followed by 12% for next 5 years and 8% for next 7 years Margin decline of 40 bps each year 	<ul style="list-style-type: none"> Revenue growth of 13% in next 3 yrs, followed by 10% for next 5 years and 6% for next 7 years Margin decline of 80 bps/ yr

Source: Espirito Santo Investment Bank research

Change in estimates

Our have largely retained our revenue estimates for FY13 and FY14. However, we have cut our EBITDA estimates by 2% for FY13 which is a rollover effect of lower margins in this quarter. Our EPS estimates doesn't change significantly as the cut in EBITDA estimates have been offset by higher other income.

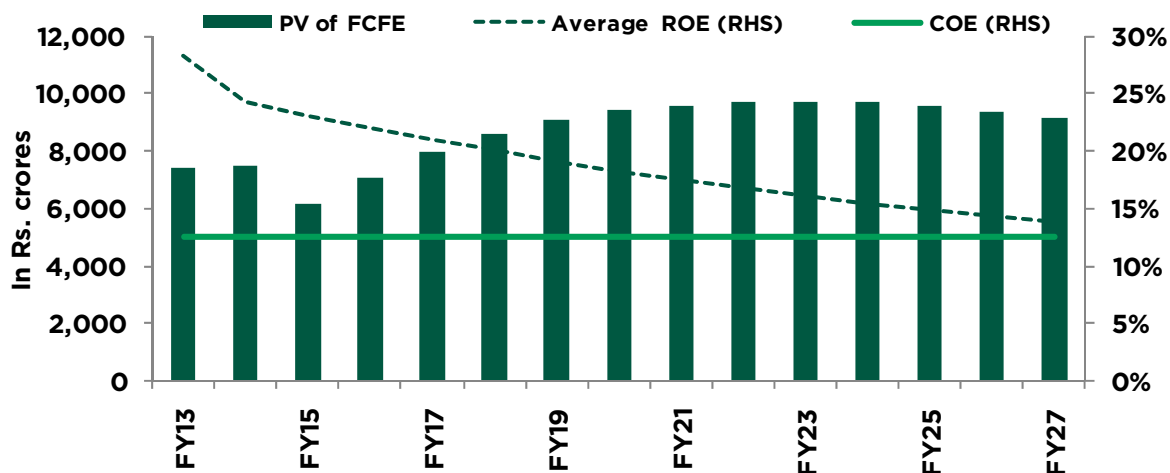
Table 3 Changes to estimates

(Rs m)	Old	New	Change %
Sales			
FY13	610,960	617,111	1%
FY14	665,282	671,912	1%
EBITDA			
FY13	184,830	180,834	-2%
FY14	196,553	196,083	0%
EPS (Rs)			
FY13	67.7	67.7	0%
FY14	71.3	71.8	1%

Source: Bloomberg, ESIB inc Execution Noble

Valuations

Figure 5 TCS' FCFE Profile



Source: Company, Espirito Santo Investment Bank research estimates

Figure 6 DCF Summary

Category	Current
COE	12.5%
Terminal Growth Rate	2.5%
PV of growth phase	21,059
PV of consolidation	42,110
PV of maturation	66,742
PV of terminal value	93,498
PV of FCFE	223,410
Net Cash	
Total Equity Value	223,410

Source: Espirito Santo Investment Bank Research estimates

Figure 7 DCF Sensitivity

Terminal Growth	WACC				
	10.5%	11.5%	12.5%	13.5%	14.5%
0.5%	1,391	1,209	1,062	941	841
1.0%	1,426	1,235	1,081	956	852
1.5%	1,466	1,263	1,102	971	864
2.0%	1,510	1,294	1,125	988	876
2.5%	1,559	1,329	1,150	1,006	890
3.0%	1,615	1,368	1,177	1,027	905
3.5%	1,679	1,412	1,208	1,049	921
4.0%	1,753	1,461	1,243	1,073	939
4.5%	1,840	1,518	1,281	1,101	959

Source: Espirito Santo Investment Bank Research estimates

Risk to our call

- 1. Growth through vendor consolidation** - A gain in share through large vendor consolidation deals could be a risk to our estimates. However, we believe that with other players also becoming equally aggressive in this segment, this is an upside risk to every company.

Summary Financials (All figures in Rsmn, year ends in March)

TCS

Recommendation:

NEUTRAL

Fair Value:

INR 1150

Share Price:

1,233

Upside / Downside

-7%

3 Month ADV (\$m)

42

Free Float

26.0%

52 Week High / Low

INR 1,295 - 903

Bloomberg:

TCS IN

Model Published On:

14 July 2012

Shares In Issue (mm)

1,957

Market Cap (\$mm)

43,877

Net Debt (\$mm)

-1,605

Enterprise Value (\$mm)

42,272

Valuation Metrics

	2009A	2010A	2011A	2012A	2013E	2014E
P/E	46.7	35.0	27.8	22.7	18.2	17.2
Reported P/E	46.7	35.0	27.8	22.7	18.2	17.2
EV / Sales	8.6	7.9	6.3	4.7	3.6	3.3
EV / EBITDA	33.3	27.2	21.0	16.0	12.4	11.2
EV / EBIT	36.2	29.6	22.5	17.1	13.3	12.1
FCF Yield	2.1%	2.7%	2.0%	2.3%	4.1%	4.5%
Dividend yield	0.6%	1.6%	1.1%	2.0%	2.2%	2.6%

Key ratios

	2009A	2010A	2011A	2012A	2013E	2014E
EBITDA margin	25.8%	29.0%	30.0%	29.5%	29.3%	29.2%
EBIT margin	23.7%	26.6%	28.0%	27.6%	27.4%	27.0%
Capex / Revenue	4.0%	3.5%	4.5%	4.1%	3.5%	3.1%
Capex / Depreciation	1.92	1.45	2.23	2.21	1.86	1.42
Net Debt / EBITDA	-0.3	-0.5	-0.6	-0.7	-0.9	-1.1
EBITDA / Net Interest	134.1	259.6	369.7	1,839.0	2,048.5	1,665.9
ROE	33%	33%	34%	32%	36%	32%

Forthcoming Catalysts

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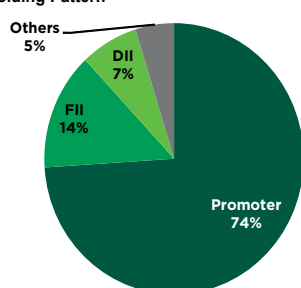
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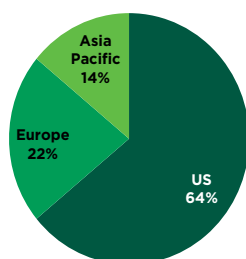
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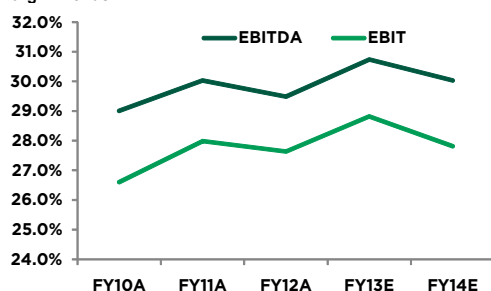
Shareholding Pattern



Revenue Breakdown



Margin Trends



P&L Summary

	2009A	2010A	2011A	2012A	2013E	2014E
Revenue	278,128	300,289	373,246	488,938	617,111	671,912
% change	21.7%	8.0%	24.3%	31.0%	26.2%	8.9%
EBITDA	71,772	87,098	112,100	144,177	180,834	196,083
% change	20.8%	21.4%	28.7%	28.6%	25.4%	8.4%
% margin	25.8%	29.0%	30.0%	29.5%	29.3%	29.2%
Depreciation & Amortisation	-5,769	-7,208	-7,626	-9,042	-11,549	-14,758
EBIT	66,003	79,890	104,474	135,135	169,285	181,325
% change	23.0%	21.0%	30.8%	29.3%	25.3%	7.1%
% margin	23.7%	26.6%	28.0%	27.6%	27.4%	27.0%
Associates	-8	-10	0	0	0	0
Operating Profit	65,995	79,880	104,474	135,135	169,285	181,325
Interest Expenses	-535	-336	-303	-78	-88	-118
Other Income	-4,136	2,591	5,006	3,212	4,020	3,924
Pre Tax Profit	61,324	82,136	109,177	138,269	173,217	185,132
Income Tax Expense	-9,011	-12,089	-21,624	-31,688	-39,486	-43,506
Minority Interests	-605	-1,018	-1,257	-1,110	-1,267	-1,172
Net Income	51,708	69,029	86,296	105,471	132,464	140,454
Execution Net Income	51,708	69,029	86,296	105,471	132,464	140,454
Reported EPS	26.42	35.27	44.35	54.35	67.68	71.76
EPS	26.42	35.27	44.35	54.35	67.68	71.76
DPS	7	20	14	25	27	32
Payout Ratio	27.0%	57.5%	31.6%	46.0%	40.0%	44.0%
Shares In Issue (Less Treasury)	1,957	1,957	1,957	1,957	1,957	1,957

Cash Flow Summary

	2009A	2010A	2011A	2012A	2013E	2014E
EBITDA	71,772	87,098	112,100	144,177	180,834	196,083
Taxes Paid	-9,011	-12,089	-21,624	-31,688	-39,486	-43,506
Interest Paid / Received	-4,672	2,256	4,703	3,134	3,932	3,807
Change in Working Capital	-29,303	-23,869	-25,711	-29,343	40,970	-21,368
Associate & Minority Dividends	0	0	0	0	0	0
Other Operating Cash Flow	25,439	21,562	-430	-10,840	-64,694	-5,214
Operating cash flow	54,226	74,958	69,038	75,440	121,556	129,801
Capital Expenditure	-11,088	-10,448	-16,977	-19,982	-21,521	-21,000
Free Cash Flow	43,138	64,510	52,060	55,458	100,035	108,801
Acquisitions & Disposals	-24,453	-129	0	0	0	0
Dividends Paid To Shareholders	-16,061	-19,584	-45,646	-38,670	-61,472	-66,157
Equity Raised / Bought Back	39	54	0	0	0	0
Other Financing Cash Flow	424	-48,042	-1,585	-12,029	-8,099	4,042
Net Cash Flow	3,088	-3,191	4,829	4,759	30,464	46,687

Balance Sheet Summary

	2009A	2010A	2011A	2012A	2013E	2014E
Cash & Equivalents	30,697	48,048	65,792	100,675	168,095	214,782
Tangible Fixed Assets	37,495	41,706	52,340	64,548	78,347	87,772
Goodwill & Intangibles	34,146	32,415	32,455	34,929	35,373	35,373
Investment in Equity Investee	14	17	0	0	0	0
Other Assets	124,507	152,359	182,021	211,838	240,693	292,406
Total Assets	226,858	274,546	332,608	411,990	522,508	630,333
Interest Bearing Debt	6,913	2,418	2,540	1,266	2,102	2,102
Other Liabilities	59,302	57,689	72,014	79,215	151,251	183,619
Total Liabilities	66,214	60,106	74,555	80,481	153,353	185,721
Shareholders' Equity	157,545	210,384	253,389	326,233	363,651	439,308
Minority Interests	3,098	4,056	4,663	5,276	5,506	5,506
Total Equity	160,644	214,439	258,053	331,509	369,157	444,814
Net Debt	-23,784	-45,631	-63,251	-99,410	-165,993	-212,680

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IMPORTANT DISCLOSURES

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SELL	Analyst expects at least 10% downside potential to fair value, which should be realized in the next 12 months

TRADING RATING	DEFINITION
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	Count	% of Total	Count	% of IBC	% of Total
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Buy	232	48.0%	29	67.4%	6.0%
Neutral	172	35.6%	8	18.6%	1.7%
Sell	72	14.9%	2	4.7%	0.4%
Restricted	5	1.0%	4	9.3%	0.8%
Under Review	0	0.0%	0	0.0%	0.0%
Trading Rating:					
Trading Buy	0	0.0%	0	0.0%	0.0%
Trading Sell	2	0.4%	0	0.0%	0.0%
Total recommendations	483	100%	43	100%	8.9%

For further information on Rating System please see “Definitions and distribution of ratings” on: <http://www.espiritosantoib-research.com>.

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