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March 06, 2006

Tata Consultancy Services

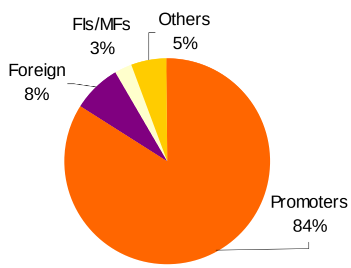
Evergreen

Bigger the better

Buy; CMP: Rs1,705

Company details	
Price target:	Rs1,980
Market cap:	Rs81,857 cr
52 week high/low:	Rs1,754/1,093
NSE volume: (No of shares)	588,556
BSE code:	532540
NSE code:	TCS
Sharekhan code:	TCSCONS
Free float: (No of shares)	7.7 cr

Shareholding pattern



Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	5.1	10.9	20.4	24.8
Relative to Sensex	-3.4	-6.3	-10.4	-21.4

Key points

- **Leader all the way:** In addition to being the largest information technology (IT) services vendor, Tata Consultancy Services (TCS) has the largest practice in most of the fast-growing new service offerings like package implementation, remote infrastructure, testing and engineering services, which is something not highlighted in its consolidated reporting structure.
- **Boosting the BPO business:** TCS lagged behind its peers in terms of the ramp-up in the business process outsourcing (BPO) business. However, the recent acquisition of Chile-based Comicrom and the take over of assets in the Pearl deal has dramatically enhanced the scale of the company's BPO operations and more importantly the skill pool in the lucrative insurance and pension industry vertical.
- **Eyeing the large deals:** Given the range of its offerings, the scale of operations in each horizontal practice and its global delivery presence, TCS is ahead of some of its peers in terms of bagging large outsourcing deals. It is effectively leveraging its leadership position to aggressively exploit the vast opportunities emerging from the scheduled renewal of the numerous outsourcing deals globally.
- **Margin pressure can be mitigated:** The concerns related to the severe pressure on its profitability from the integration of low-margin acquisitions and some large outsourcing deals have resulted in the scrip's underperformance on the bourses. However, the company has levers to mitigate the adverse impact in the short-term and improve the overall profitability gradually over the coming quarters.
- **Limited downside risk:** Given the scrip's recent underperformance, the premium attracted by TCS over the benchmark indices has narrowed down considerably and would limit the downside. With the estimated earnings per share compounded annual growth rate (CAGR) of over 25% in the two-year period FY2006-08, we recommend a Buy on the stock with a target price of Rs1,980, which works out to 21x its FY2008E earnings (lower than the 22x target multiple assigned by us to Infosys).

Company background

TCS has emerged as the largest domestic IT services vendor in terms of the revenues as well as its employee base. It is a prized jewel of the Tata group—one of Asia's largest conglomerates.

Key financials

	FY2005	FY2006E	FY2007E	FY2008E
Net profit (Rs cr)	2,052.0	2,823.0	3,657.0	4,604.0
Shares in issue (cr)	48.0	48.0	48.9	48.9
EPS (Rs)	42.7	58.8	74.7	94.1
% y-o-y change		*37.6*	*27.1*	*25.9*
PER	39.9	29.0	22.8	18.1
OPM (%)	27.7	26.9	25.3	25.4
RONW (%)	64.2	50.4	42.9	38.0
ROCE (%)	56.6	44.6	40.8	37.6

TCS pioneered the offshore delivery IT services model. It has a presence in 34 countries across six continents and offers a comprehensive range of services ranging from consulting, application development, maintenance, testing, IT infrastructure, software products and business process outsourcing (BPO).

Apart from its overseas subsidiaries in the IT services business, the other major subsidiaries are CMC Limited (focused on system integration and solutions businesses in the domestic market), AFS, TCS Business Transformation and a subsidiary formed by the recently signed deal to acquire the business processes of the UK-based Pearl group.

Investment arguments

Comprehensive range of offerings

In addition to the traditional businesses of application development & maintenance, TCS has been able to significantly ramp-up the relatively newer and fast-growing service offerings like package implementation, IT infrastructure services, testing and consulting services, and is the leader in most of the segments. For instance, TCS' revenues from enterprise solution and package implementation practice grew by over 35% to Rs2,049 crore in the first nine months of FY2006, which is almost double than the Rs1,090 crore reported by Infosys.

Similarly, in the case of remote infrastructure services, the company scores over its peers like HCL Technologies (HCLT) and Wipro, which are known for their reasonably large-sized operations in the remote infrastructure practice. In this practice, TCS has 112 active clients and a base of 2,375 employees generating annual revenues of around $200 million—almost double the size of HCLT.

It is also ahead of its competitors in the case of the other fast growing services like engineering services and assurance & testing, where the company has acquired a reasonably large number of active clients and has the largest pool of skilled employee base.

Other service offerings

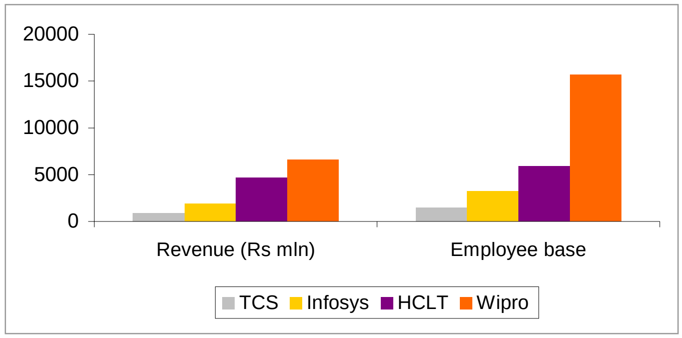
	Active clients	Employees
IT Infrastructure services	112	2375
Engineering services	315	3400
Assurance services	72	25*

*25 number of Centre of excellence

Strengthening the weak link

TCS was lagging behind in the BPO business with revenues of around $20 million (employee base of around 1,500) in FY2005, which was much lower than the $105 million reported by HCLT and $148 million reported by Wipro.

BPO business comparison (FY2005)



However, the company has significantly ramped up its BPO business with aggressive inorganic initiatives taken recently. With the acquisition of Chile-based Comicrom (1,257 employees) and the inclusion of 950 employees from the Pearl deal, the employee base stood at 4,598 at the end of December 2005. Consequently, TCS is expected to more than double its BPO revenues to $43 million in FY2006. But more importantly, the groundwork has been done for the big push in FY2007 when the revenues from Comicrom and the Pearl deal will get fully reflected in its performance. It is expected to report revenues of $150-155 million from the BPO business in FY2007.

The inorganic initiatives have also provided diversity in the form of delivery centres in Latin America (Comicrom) and Europe (Pearl). Moreover, it would have one of the largest BPO practices in the insurance and pension industry domain.

Inorganic boost

Comicrom	The Chile-based BPO major reported a revenue run rate of $35 million and margins of 14% in FY2005. Acquired for $23 million in November 2005.
FNS	The Australia-based core banking product company had reported revenues of $22 million in CY2004. It was acquired for $22.5 million in October 2005.
Pearl deal	In a first of its kind deal by a domestic vendor, Pearl will transfer administrative operations of 4 million life and pension policies along with the existing staff of 950 associates based in the UK. It is a 12-year outsourcing contract worth $847 million. The billing will commence from Q1FY2007 and has an annual run rate of Rs380-390 crore.

Vying for bigger deals

With the enhanced range of service offerings, the leading Indian vendors like TCS have not only considerably increased the target market segment but are also better placed to effectively compete for large outsourcing deals. The ability to corner large outsourcing deals is becoming an imperative to support the growth at the fairly large base. And TCS has been ahead of some of its peers like Infosys and Satyam in terms of its success in bagging large deals.

Large deals bagged

ABN Amro	$240 million over five years
Tata Teleservices	$250 million over five years
Pearl Group	$847 million over 12 years

Other large deals include Citibank, Deutsche Bank, SAP, NHS etc.

Fortunately for the Indian vendors many large outsourcing deals signed in late 1990s and the early part of this decade are scheduled to be renewed over the next 24-30 months. The size of this opportunity is expected to be in the range of $80-90 billion. Though the existing global vendors like Hewlett Packard, EDS, Accenture, IBM Global etc are expected to corner 80-85% of the business, it still throws open a large opportunity for the Indian vendors. We believe that the aggressive focus on large outsourcing deals would enable TCS to bag a sizeable portion of this huge opportunity that could flow to the Indian vendors.

Apart from its leadership position, TCS also has the advantage of having a sales and marketing presence in 34 countries and 18 global delivery centres in 9 countries, which provides the geographical reach and diversity required to be globally competitive.

Margins, the only sore point

Though the inorganic initiatives have significantly strengthened the BPO operations and enhanced its geographical presence, TCS is likely to witness severe pressure on its margins as most of the recently acquired companies operate at a much lower level of profitability. For instance, Comicrom has earnings before interest and tax (EBIT) margins of 14% while FNS is a loss making company. Moreover, the Pearl business is largely onsite-centric and has EBIT margins of 8% only.

If this wasn't enough, the amalgamation of Tata Infotech (TIL) will drag down the overall profitability as it operates at 9.4-9.5% operating margins and will account for around 7.5% of the consolidated revenues going by the performance in FY2006. Moreover, it will result in a dilution of 1.9% of the equity due to the issue of fresh equity shares to the existing shareholders of TIL. The above factors cumulatively would depress the margins by 180-200 basis points in the next couple of quarters. Consequently, we have assumed a 160-basis-point decline in the operating profit margins (OPM) to 25.3% in FY2007 (including the TIL performance from FY2007 though it will get amalgamated in Q4FY2006 with retrospective effect from April 1, 2005).

However, the management expects to perform better on the profitability front by aggressive restructuring TIL's operations. The key levers to improve TIL's margins are: redundancy of all support functions, the scope to increase the employee utilisation rate by 10% to over 75% (as many employees can be immediately made billable by deploying them in the testing & assurance practice) and lastly through the gradual reduction of the low-margin hardware component business. We have assumed a 10% decline in the revenues, but a 250-basis-point improvement in the OPM of TIL during FY2007.

Other levers of margin improvement

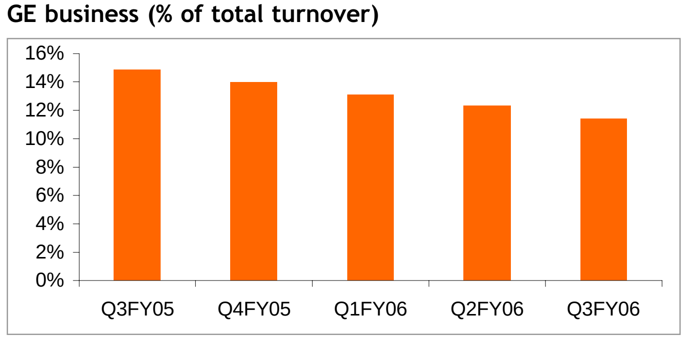
Apart from the restructuring of the acquired companies, TCS has other margin improvement levers available in the overall IT services business like the offshore-onsite revenue mix, expansion of the employee pyramid and the continued decline in the proportion of the low-margin GE business.

First, the high-margin offshore revenues contributed 38.6% to the total revenues as compared to over 50% in the case of its peers. Any improvement on this front can substantially boost the overall profitability as the gross margin in the case of offshore component is close to double that of the onsite business.

The company already appears to be working on the second lever of expanding the employee base by a higher intake of freshers. The company indicated in the last conference call that around 10,000 offer letters have been given to fresh graduates in this year's campus recruitment season. But the company will still have to tackle the tricky issue of realigning its wage structure in line with its peers, especially for the onsite employees. The company has taken some corrective steps earlier this fiscal. It gave an aggressive average salary increment of 4% to the onsite employees in Q1, which was followed by another marginal onsite compensation hike in the second quarter.

Lastly, the steady decline in the proportion of the low-margin GE revenues to the total turnover is another positive factor for the overall profitability. The profitability in the GE business is estimated to be almost half of the overall average. We expect the contribution from the GE business to decline below 9% and 7.4% in FY2007 and FY2008 respectively.

GE business (% of total turnover)



Taking the above-mentioned factors into account, we estimate the earnings per share to grow at a CAGR of over 25% in the two-year period FY2006-08E in spite of the margin pressure.

Valuation

We recommend a Buy on the stock with a target price of Rs1,980 that amounts to 21x its FY2008 estimated earnings (a slight discount to the target multiple of 22x given for Infosys).

Profit and loss account Rs (cr)

Particulars	FY05	FY06E*	FY07E	FY08E
Revenue	9727	12442	17234	21568
Operating expenses	7035	9101	12882	16092
Operating profit	2693	3341	4352	5476
Other income	76	22	40	50
Profit before tax	2768	3363	4392	5526
Tax	406	518	703	884
PAT	2362	2845	3689	4642
Affiliates earnings	2	0	0	0
Minority interest	8	23	32	38
PAT before one-time items	2356	2823	3657	4604
One-time item	304	0	0	0
PAT	**2052**	**2823**	**3657**	**4604**

Balance sheet Rs (cr)

Particulars	FY05	FY06E*	FY07E	FY08E
Equity capital	48	48	49	49
Reserves & surplus	3150	5549	8475	12065
Networth	3198	5597	8523	12114
Current liabilities	1512	1739	2000	2300
Other liabilities	48	56	64	73
Minority interest	132	152	175	201
Total liabilities	**4891**	**7544**	**10762**	**14689**
Net fixed assets	1087	1467	1981	2674
Investments	418	585	820	1148
Current assets	3059	5099	7492	10303
Other current assets	327	392	470	564
Total assets	**4891**	**7544**	**10762**	**14689**

Key ratios (%)

	FY05	FY06E*	FY07E	FY08E
GPM	46.3	46.8	45.2	45.2
OPM	27.7	26.9	25.3	25.4
NPM	24.0	22.6	21.2	21.3
RONW	64.2	50.4	42.9	38.0
ROCE	56.6	44.6	40.8	37.6
EPS(Rs)	42.7	58.8	74.7	94.1
PER	39.9	29.0	22.8	18.1
Market cap/sales	8.5	6.7	4.9	3.9

*TIL performance not included in FY2006 estimated figures

The author doesn't hold any investment in any of the companies mentioned in the article.