Sharekhan

by BNP PARIBAS

Tata Consultancy Services

Weak quarter

Sector: IT & ITES

Result Update

	Change
Reco: **Buy**	↔
CMP: **Rs. 2,004**	
Price Target: **Rs. 2,150**	↓

↑ Upgrade ↔ No change ↓ Downgrade

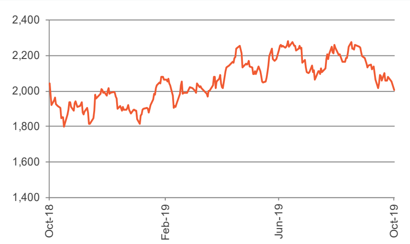
Company details

Market cap:	Rs. 752,128 cr
52-week high/low:	Rs. 2,296 / 1,784
NSE volume: (No of shares)	27.2 lakh
BSE code:	532540
NSE code:	TCS
Sharekhan code:	TCS
Free float: (No of shares)	104.9 cr

Shareholding (%)

Promoters	72.1
FII	15.9
DII	8.2
Others	3.9

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-7.5	-5.1	-2.4	-2.0
Relative to Sensex	-10.0	-4.1	-1.2	-13.0

Sharekhan Research, Bloomberg

Tata Consultancy Services (TCS) delivered lower-than-expected performance across all financial parameters. Constant currency (CC) revenue growth on a y-o-y basis decelerated to 8.4% from 12.7/10.6% y-o-y in Q4FY2019/Q1FY2020. Revenue growth stood at around 1.5% q-o-q CC, below our estimates, owing to softness in BFSI and lower-than-expected performance in retail and CPG and emerging markets verticals. EBIT margin during the quarter declined by 14 BPS q-o-q/250 BPS y-o-y to 24.0%, much below our estimate of 25.6%, owing to higher investments in people, lower revenue growth and lack of benefits from rupee. Digital business revenue growth decelerated to 27.9% owing to softness in retail, as retail has been a big adopter of digital technologies. TCS reported strong deal TCV of $6.4 billion (versus $5.7 billion in Q1FY2020) at the time of macro uncertainties, which indicates strong competitive positioning of TCS's offerings. With weak results in H1FY2020, we believe the double-digit revenue growth target of TCS is at risk, considering weak seasonality of H2. Management hopes EBIT margin would bounce back in the coming quarters on account of pyramid rationalisation, improving utilisation and control on subcontracting expenses.

Key Positives

- TCS signed strong TCV of $6.4 billion in Q2FY2020 (strong book-to-bill of 1.16x), up 12% q-o-q and 31% y-o-y
- Management declared special dividend of Rs. 40 per share, in-line with its capital allocation policy (80-100% of FCF)
- Added three clients on a sequential basis under the $100 million client bucket

Key Negatives

- EBIT margin contracted by 14 BPS q-o-q despite absence of wage hike, below our estimates
- Weakness in the retail vertical impacted growth of the digital business (27.9% in Q2FY2020 vs. 42.1% in Q1FY2020)

Our call

Valuation – Maintain Buy with a revised PT of Rs. 2,150: We have downgraded our earnings estimates for FY2020E/FY20121E, factoring miss in revenue and profitability. However, we believe margin would recover in the coming quarters from Q2FY2020 level on account of operational efficiencies and control on subcontracting expenses. We continue to remain positive on TCS's revenue growth trajectory, given acceleration in deal wins with increasing TCVs, ability to stitch together large multi-service deals and traction for its product and platform portfolio. At the CMP, the stock is trading at 23x/21x its FY2020E/FY2021E EPS, justifying premium valuation given its consistency and leadership position coupled with strong FCF generation and investor-friendly payouts. Therefore, we maintain our Buy rating with a revised PT of Rs. 2,150.

Risk: Rupee appreciation and/or adverse cross-currency movements and/or constraint in local talent supply in the U.S. along with stringent visa regime would have an adverse impact on its earnings.

Valuation Rs cr

Particulars	FY17	FY18	FY19	FY20E	FY21E
Revenue	1,17,966.0	1,23,104.0	1,46,463.0	1,57,696.6	1,73,286.9
OPM (%)	27.4	26.4	27.0	26.4	26.5
Adjusted PAT	26,289.0	25,826.0	31,472.0	32,724.2	36,005.3
% YoY growth	*8.6*	*-1.8*	*21.9*	*4.0*	*10.0*
Adjusted EPS (Rs.)	70.1	67.1	83.1	87.2	96.0
P/E (x)	28.6	29.9	24.1	23.0	20.9
P/B (x)	8.5	8.8	8.4	7.6	6.9
EV/EBITDA (x)	12.2	11.6	18.8	17.7	16.0
RoNW (%)	32.4	29.6	35.9	34.7	34.7
RoCE (%)	36.4	33.9	41.3	39.2	39.6

Source: Company; Sharekhan Research

Weak quarter

TCS delivered lower-than-expected performance across all financial parameters in Q2FY2020. Constant currency (CC) revenue growth stood at 1.5% q-o-q, below our as well as consensus estimates. Post four consecutive quarters of double-digit growth in CC terms, TCS's CC revenue growth decelerated to 8.4% during the quarter owing to softness in BFSI and incremental weakness in the retail vertical and emerging markets vertical. In USD terms, revenue growth was disappointing at 0.6% q-o-q/5.8% y-o-y versus our expectation of 1.9% q-o-q/7.2% y-o-y despite seasonally strong quarter. EBIT margin during the quarter declined by 14 BPS q-o-q/250 BPS y-o-y to 24.0%, much below our estimate of 25.6%, owing to higher investments in people, lower revenue growth and lack of benefits from rupee. Lower profitability resulted in a 1.1% q-o-q decline in net income at Rs. 8,042 crore, below our estimates.

H2 seasonally weak, target for double-digit revenue growth looks challenging

With weak results in H1FY2020, we believe the double-digit revenue growth target of TCS is at risk considering weak seasonality of H2 owing to furloughs, low working days and budget-cycle for most large global enterprises. Further, the company continues to see weakness in BFSI (especially in capital markets and European banks), retail (U.S. and U.K.) and regional markets (especially in emerging markets), which together constitute a large chunk of its total revenue. However, management remains optimistic on the medium-to-long-term demand outlook despite macro challenges, as it has not witnessed any cut back of spends from its clients. Management also believes the growth trajectory for its retail vertical could accelerate in Q3FY2020E (10.5% in Q3FY2019) because of the upcoming holiday season. We believe strong deal wins, competitive differentiation, ability to stitch together large multi-service deals and traction for its product and platform business would help TCS to grow faster than large peers.

Pyramid rationalisation likely to improve margin

TCS has historically demonstrated significant bouncing back of margins to the aspirational band post a decline in margins. TCS has been reporting EBIT margin below its aspirational band for the past four consecutive quarters. EBIT margin during the quarter was impacted by investment in people (net addition of 14,097 employees, highest in any quarter in the past six years). Management believes EBIT margin would bounce back in the coming quarters on account of pyramid rationalisation, improving utilisation (tweaking hiring in coming quarters) and control on subcontracting expenses. Further, margin of the retail and BFSI verticals would improve with the return of growth in the respective vertical.

Key result highlights from earnings call

- **Large deal wins:** Strong deal wins continued in Q2FY2020, with deal TCVs of $6.4 billion (versus $5.7 billion in Q2FY2019), an increase of around 31% y-o-y/12% q-o-q. Book-to-bill ratio during the quarter stands at 1.16x in Q2FY2020 versus 1.04x in Q1FY2020. TCS signed deals worth $3.4 billion (versus $2.8 billion in Q2FY2018) in North America, $2.2 billion in BFSI (highest in the past six quarters) and $830 million in retail.
- **Client metrics:** TCS added three clients on a sequential basis under the $100 million client bucket during the quarter, taking its total clients to 47. The number of US$50 million clients was increased by one on a q-o-q basis and by three on a y-o-y basis. The number of clients under the $20 million and $10 million client bucket increased by six and 14 clients on a sequential basis, respectively.
- **BFSI vertical outlook:** BFSI CC revenue growth decelerated to 8% y-o-y in Q2FY2020 compared to 9.2% y-o-y in Q1FY2020. Management continues to see softness in U.S. capital markets and large European banks. The insurance vertical continued to grow well during the quarter. Management sees significant strength in insurance and regional banks and smaller banks in North America.
- **Retail vertical outlook:** The retail vertical's CC revenue growth decelerated to 4.8% y-o-y during the quarter. Though clients continue to invest strongly in new technology initiatives, management is adopting the wait-and-watch approach to see whether growth would accelerate in Q3FY2020E.
- **Digital business:** Digital revenue (33.2% of total revenue) continued its growth momentum, growing by 27.9% y-o-y on CC basis. Digital revenue growth was impacted by softness in retail, as retail has been a big adopter of digital technologies.
- **Hiring:** Net addition was strong at 14,097 during the quarter, highest in any quarter in the past six quarters. The company has done net hiring of around 26,453 employees in the past two quarters. Management focuses on rationalisation of the employee pyramid in the medium-to-long term. Management believes such entry-level hiring would offset temporary lateral hires.
- **Product and platform:** TCS has built its products and platforms business organically through investment over the past few years. Ignio is TCS's cognitive automation software platform, which has 10 new wins and eight go-lives during the quarter. TCS BaNCS has six new wins and six go-lives in Q2FY2020.

Results | Rs cr

Particulars	Q2FY20	Q2FY19	Q1FY20	YoY (%)	QoQ (%)
Revenue ($ mn)	**5,517.0**	**5,215.0**	**5,485.0**	**5.8**	**0.6**
Revenue in INR (cr)	38,977.0	36,854.0	38,172.0	5.8	2.1
Direct costs	22,410.0	20,795.0	22,102.0	7.8	1.4
Gross profit	16,567.0	16,059.0	16,070.0	3.2	3.1
SG&A	6,341.0	5,781.0	6,033.0	9.7	5.1
EBITDA	**10,226.0**	**10,278.0**	**10,037.0**	**-0.5**	**1.9**
Depreciation	865.0	507.0	817.0	70.6	5.9
EBIT	**9,361.0**	**9,771.0**	**9,220.0**	**-4.2**	**1.5**
Other income	1,168.0	593.0	1,418.0	97.0	-17.6
PBT	10,529.0	10,364.0	10,638.0	1.6	-1.0
Tax provision	2,471.0	2,437.0	2,485.0	1.4	-0.6
Net profit	**8,058.0**	**7,927.0**	**8,153.0**	**1.7**	**-1.2**
Minority interest	16.0	26.0	22.0	-38.5	-27.3
Adj. Net Profit	8,042.0	7,901.0	8,131.0	1.8	-1.1
EPS (Rs.)	21.4	21.1	21.7	1.8	-1.1
Margin (%)				**BPS**	**BPS**
EBITDA	26.2	27.9	26.3	-165	-6
EBIT	24.0	26.5	24.2	-250	-14
NPM	20.6	21.4	21.3	-81	-67

Source: Company; Sharekhan Research

Operating metrics | Rs cr

Particulars	Revenue ($ mn)	Contribution (%)	$ Growth (%) q-o-q	$ Growth (%) y-o-y	CC growth (%) y-o-y
Revenue ($ mn)	**5,517**	**100**	**0.6**	**5.8**	**8.4**
Geographic mix					
North America	2,792	50.6	0.6	4.8	5.3
Latin America	105	1.9	6.2	0.5	7.3
U.K.	861	15.6	-0.7	5.8	13.3
Continental Europe	805	14.6	2.7	10.3	16.0
India	314	5.7	-4.4	7.7	7.7
APAC	519	9.4	0.6	3.6	6.5
MEA	121	2.2	5.4	10.8	7.3
Industry verticals					
BFSI	1,710	31.0	1.2	5.1	8.0
Retail & CPG	817	14.8	-0.8	1.7	4.8
Communication & media	386	7.0	2.0	7.3	11.8
Manufacturing	541	9.8	0.6	5.8	7.8
Life Science and healthcare	447	8.1	3.1	14.3	16.0
Technology & services	480	8.7	-0.6	3.4	5.6
Regional markets and others	1,137	20.6	-0.4	6.8	9.3
Digital	**1,832**	**33.2**	**3.7**	**25.4**	**27.9**
Core	**3,685**	**66.8**	**-0.9**	**-1.8**	**NA**

Source: Company; Sharekhan Research

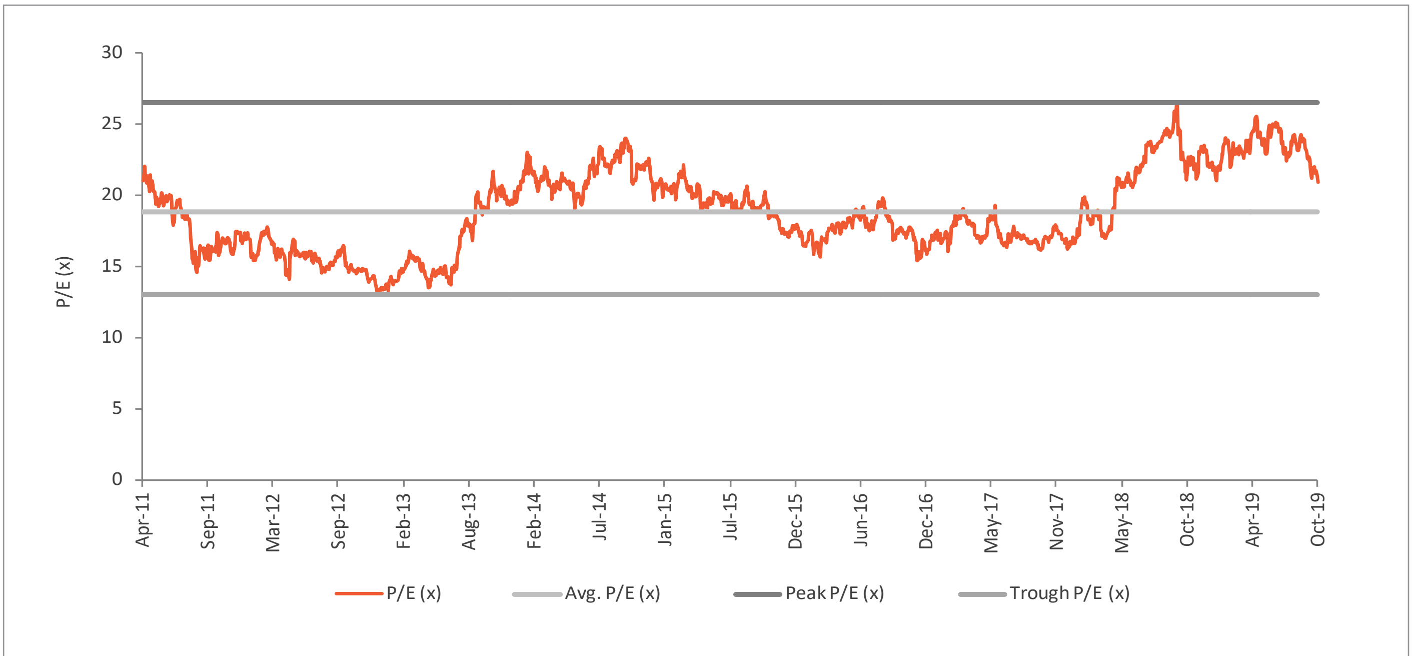
Outlook

Being the largest IT services company in India, TCS is well positioned to benefit from the growing demand for digital technology. Further, the company is well placed from a competitive perspective, especially in newer technologies. A stable management along with the ability to structure large multi-service deals and resilient margin performance would help TCS maintain its growth trajectory in the long term. While there are macro uncertainties in major markets, management indicated that client discussions do not indicate any lowering of spending yet. Management intends to keep the payout ratio at 80-100% of free cash generated.

Valuation

We have downgraded our earnings estimates for FY2020E/FY20121E, factoring miss in revenue and profitability. However, we believe margin would recover in the coming quarters from Q2FY2020 level on account of operational efficiencies and control on subcontracting expenses. We continue to remain positive on TCS's revenue growth trajectory, given acceleration in deal wins with increasing TCVs, ability to stitch together large multi-service deals and traction for its product and platform portfolio. At the CMP, the stock is trading at 23x/21x its FY2020E/FY2021E EPS, justifying premium valuation given its consistency and leadership position coupled with strong FCF generation and investor-friendly payouts. Therefore, we maintain our Buy rating with a revised PT of Rs. 2,150.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer valuation

Particulars	CMP	O/S	Mcap	P/E (x)		EV/EBIDTA (x)		P/BV (x)		RoE (%)	
	Rs/share	cr	Rs cr	FY20E	FY21E	FY20E	FY21E	FY20E	FY21	FY20E	FY21
HCL Tech	1,064	136	1,47,383	14.3	12.9	9.1	8.3	3.1	2.8	23.0	22.8
Infosys	783	430	3,36,259	20.3	17.9	14.1	12.5	2.8	2.8	25.6	29.0
Tech M	711	96	68,551	14.8	12.7	9.5	7.6	3.0	2.7	19.3	19.8
Wipro	239	603	1,44,302	14.6	13.1	9.3	8.0	2.9	2.6	17.9	18.1
TCS	2,004	375	7,52,128	23.0	20.9	17.7	16.0	7.6	6.9	34.7	34.7

Source: Sharekhan Research

About company

TCS is among the pioneers of IT services outsourcing business in India and is the largest ($20,913 million revenue in FY2019) IT services firm in terms of export revenue. Incorporated in 1968, the company provides a comprehensive range of IT services to industries such as BFS, insurance, manufacturing, telecommunications, retail and transportation. TCS is well positioned to benefit from growing demand for offshore IT services, given its solid execution capabilities, long-standing relationships with clients, and stable management team. The company is a serious contender for winning large deals, as it has better experience compared to peers in implementing large, complex and mission-critical projects. TCS is one of the preferred IT vendors for most Fortune 500/Global 1,000 companies.

Investment theme

TCS is one of the leading IT services companies with a wide-range of capabilities, robust digital competencies, strong platform and stable management. The company is the preferred partner of large corporates and is increasing its participation in large digital implementation. Hence, we believe TCS would continue to gain market share in digital versus its large peers, given its superior execution capabilities on the digital front. We remain positive on the sustainability of its revenue growth momentum in the medium term, given the acceleration in deal wins with increasing TCVs, broad-based service offerings, higher budgets from clients toward digital technologies and improving sales expertise.

Key Risks

1) Rupee appreciation and/or adverse cross-currency movements, 2) slackening pace in deal closures, and 3) crunch in local talent supply in the U.S. along with stringent visa regime.

Additional Data

Key management personnel

Management	Designation
N. Chandrasekaran	Chairman
Rajesh Gopinathan	Chief Executive Officer
N. Ganapathy Subramaniam	Chief Operating Officer
V Ramakrishnan	Chief Financial Officer
Milind Lakkad	EVP and Global Head

Source: Company

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Tata Sons Pvt Ltd	72.0
2	Life Insurance Corp of India	4.0
3	BlackRock Inc	0.9
4	Vanguard Group Inc	0.9
5	Commonwealth Bank of Australia	0.8
6	JPMorgan Chase & Co	0.8
7	SBI Funds Management Pvt Ltd	0.6
8	Invesco Ltd	0.5
9	Standard Life Aberdeen PLC	0.4
10	Axis Asset Management Co Ltd	0.4

Source: Bloomberg

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