Sharekhan by BNP PARIBAS

Tata Consultancy Services

Rich valuation, downgrade to Hold

Sector: IT & ITES

Company Update

	Change
Reco: **Hold**	↓
CMP: **Rs. 2,223**	
Price Target: **Rs. 2,300**	↑

↑ Upgrade ↔ No change ↓ Downgrade

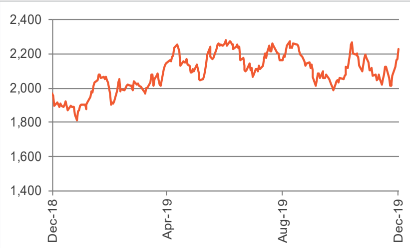
Company details

Market cap:	Rs. 833,986 cr
52-week high/low:	Rs. 2,296/1,809
NSE volume: (No of shares)	30.6 lakh
BSE code:	532540
NSE code:	TCS
Sharekhan code:	TCS
Free float: (No of shares)	104.9 cr

Shareholding (%)

Promoters	72.1
FII	15.5
DII	8.5
Others	4.0

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	5.7	8.4	1.1	17.2
Relative to Sensex	2.6	-6.2	-5.8	1.5

Sharekhan Research, Bloomberg

We recently met the management of TCS to understand the demand environment (especially BFSI, retail and manufacturing), conversion of backlog into revenue and margin outlook. Management cited that growth of both BFSI and retail verticals (together account for 46% of total revenue) would further moderate in Q3FY2020E owing to continued weak spending in the capital markets segment in the U.S. and large banks in Europe and delay in deal closures in the retail space due to slowdown in decision making. Management also expects higher impact of furloughs, lower working days and certain macro issues to impact the growth momentum in Q3FY2020E. However, the organic growth rate (on a large base) of its BFSI vertical remains strong among large global peers given its ability to stitch together large and complex deals and quality of solutions. Despite strong book-to-bill ratio (in the range of 1-1.16x), slowdown in revenue growth momentum in the past couple of quarters was primarily due to leakage in existing/old projects (delay/cut in spends of maintenance/support relating works). Management highlighted that growth momentum of both manufacturing and life science and health verticals would continue, led by recovery in auto sub segment, growth in the engineering division (third largest globally) and strong traction for its products and platforms among pharma/drug companies.

Expect margin to remain steady in 2HFY2020: Though TCS's operating profitability continues to remain strong compared to its peers because of its effective cost-control measures, lower attrition and strong competitive position, the company's EBIT margin was impacted in 1HFY2020 owing to wage hike, increasing subcontracting expenses, higher investments in people and capabilities, increasing onsite costs and lower revenue growth. The company had net addition of 26,453 employees during the first half of FY2020E. Management expects margins to remain steady/marginal improvement in 2HFY2020E because of pyramid rationalisation, improving utilisation, higher digital revenue contribution and operational efficiencies, partially offset by weaker revenue growth and continued increase in overseas cost structure.

Our Call

Valuation – Valuations are stretched; downgrade to Hold with a revised PT of Rs. 2,300: We expect TCS's constant currency (CC) revenue growth on a y-o-y basis would moderate in Q3FY2020E owing to slowdown in both the BFSI and retail verticals (together account for ~46% of total revenue) and higher impact of furloughs. Further, leakage in existing/old projects and/or delay in decision making on spending programmes owing to uncertain macros and upcoming election could impact its growth in the near term. However, we continue to like TCS on account of strength in its business model, consistency, solid execution and strong FCF generation profile. We have introduced FY2022E numbers in this note. At the CMP, the stock is trading at 26x/23x its FY2020E/FY2021E earnings, making risk-reward ratio unfavourable when demand is moderating. Hence, we downgrade our rating from Buy to Hold on the stock with a revised PT of Rs. 2,300.

Key Risks

Rupee appreciation and/or constraints in local talent supply in the U.S. along with stringent visa regime and escalation of trade wars could adversely affect earnings.

Valuation Rs cr

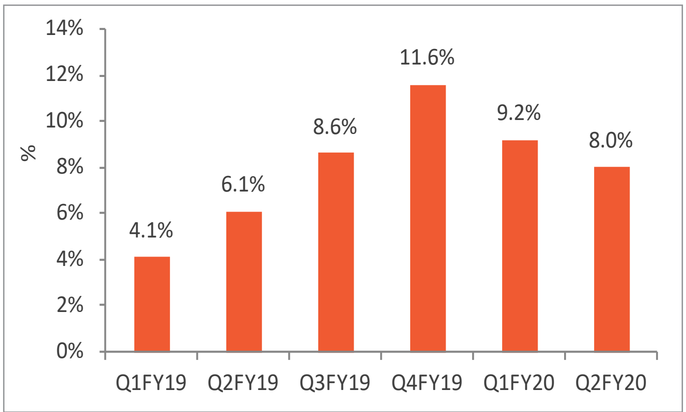
Particulars	FY18	FY19	FY20E	FY21E	FY22E
Revenue	1,23,104.0	1,46,463.0	1,57,200.1	1,72,817.0	1,86,946.0
OPM (%)	26.4	27.0	26.5	26.6	26.7
Adjusted PAT	25,826.0	31,472.0	32,665.9	35,796.7	39,214.2
% YoY growth	*-1.8*	*21.9*	*3.8*	*9.6*	*9.5*
Adjusted EPS (Rs.)	67.1	83.1	87.1	95.4	104.5
P/E (x)	33.1	26.8	25.5	23.3	21.3
P/B (x)	9.8	9.3	8.4	7.7	6.9
EV/EBITDA (x)	12.9	20.8	19.7	17.8	16.3
RoNW (%)	29.6	35.9	34.6	34.5	34.2
RoCE (%)	33.9	41.3	39.2	39.6	39.0

Source: Company; Sharekhan estimates

Weakness in BFSI and retail vertical along with furlough would lead to growth moderation

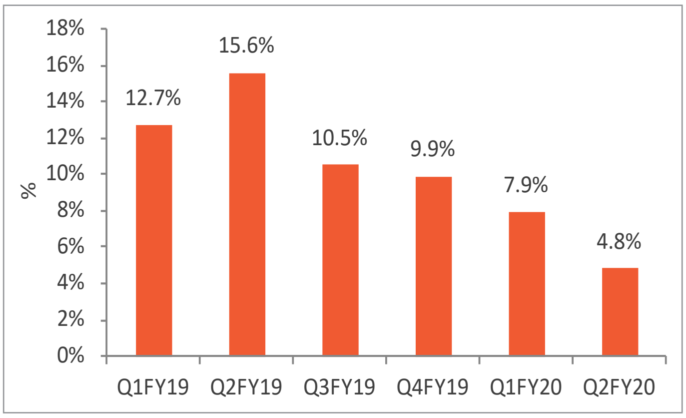
Since the past two consecutive quarters, growth of the BFSI vertical (the largest contributor to total revenue i.e. 31%) has been moderating from 11.6% y-o-y CC in Q4FY2019 to 9.2%/8% CC in Q1FY2020/Q2FY2020. The slowdown in growth was due to weak spending in the capital markets segment (especially in the U.S.) and large banks in Europe. However, large deal wins in its BFSI vertical remain strong (35% of deal wins in 1HFY2020) for TCS, given its ability to stitch together large and complex deals and quality of solutions. Apart from BFSI, the retail vertical's (14.8% to total revenue) growth declined on a sequential basis and moderated to 4.8% y-o-y in Q2FY2020 due to slowdown in decision making on spending programmes, which is expected to continue in Q3FY2020E owing to client-specific issues. Management cited that both BFSI and retail verticals (together account for ~46% of total revenue) would continue to decelerate in Q3FY2020E as well. Management also expects overall growth to be affected by furloughs, lower working days and certain macro issues.

BFSI vertical's CC growth(y-o-y)



Source: Company, Sharekhan Research

Retail vertical's CC growth (y-o-y)



Source: Company, Sharekhan Research

Large deal wins momentum remains robust, leakages in existing contracts

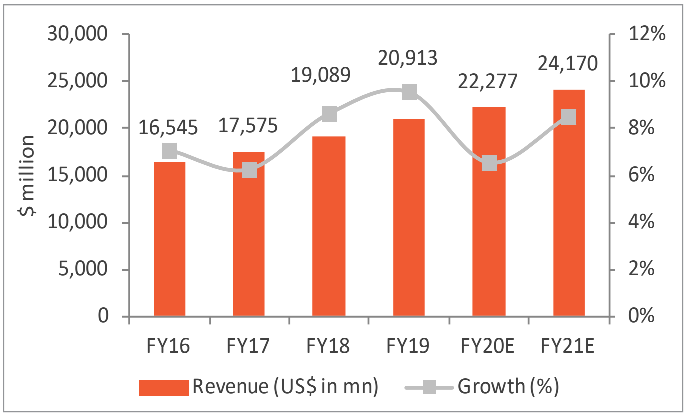
Large deal wins have remained strong for TCS, implying total deal wins of $24.2 billion/$12.1 billion on TTM/1HFY2020. North America remains the largest contributor (~50% of total deal wins) of total large deal wins among geographies. Further, quarterly book-to-bill ratio remains within the comfort band of 1x-1.16x. Despite strong deal wins, revenue growth momentum has moderated in last couple of quarters. Management mentioned that slowdown in revenue growth is primarily due to leakage in existing/old projects. Management highlighted that some maintenance and supporting works spending is getting delayed/optimised due to macro issues.

Manufacturing and life science and healthcare vertical's growth to remain strong

The manufacturing vertical's growth bounced back to 7.8% y-o-y on CC basis, led by recovery in auto sub-segment. Management cited that the manufacturing vertical would continue its growth momentum on account of ramp-up in large deals, recovery in auto sub-segment and strong growth in the engineering segment (third largest in terms of revenue across the globe). The life science and healthcare vertical is expected to continue its double-digit growth momentum, led by strong traction for products and platforms among global pharma/ drug companies. TCS generates more than $1 billion revenue from its products and platform business.

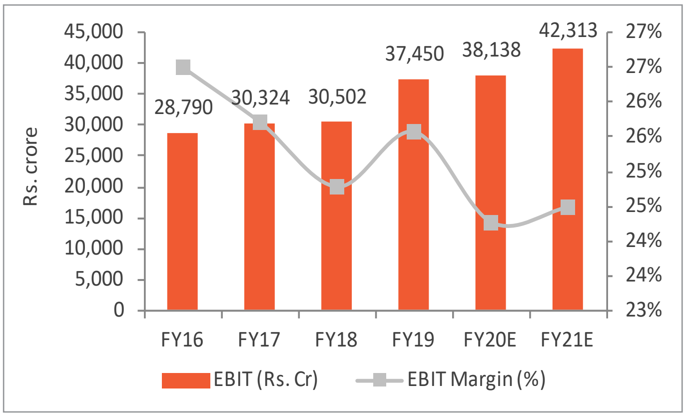
Financials in charts

Revenue in US$ (mn) and growth (%)



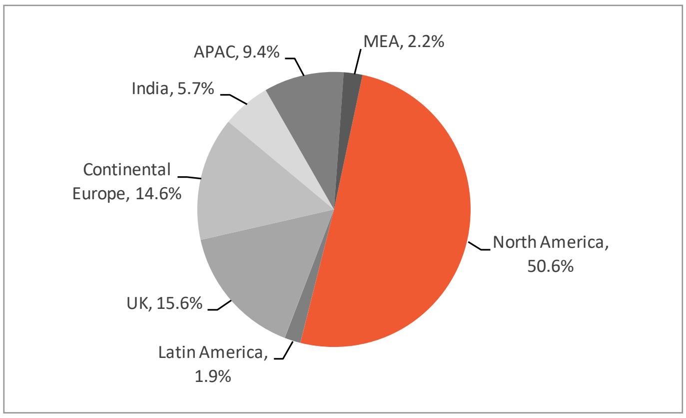
Source: Company, Sharekhan Research

EBIT (Rs. cr) and EBIT margin (%)



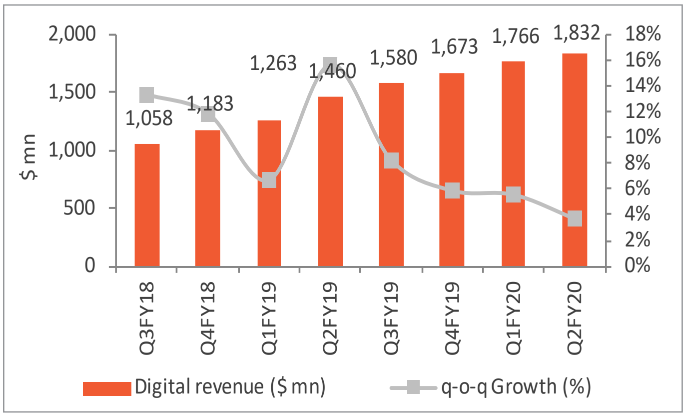
Source: Company, Sharekhan Research

Geography mix



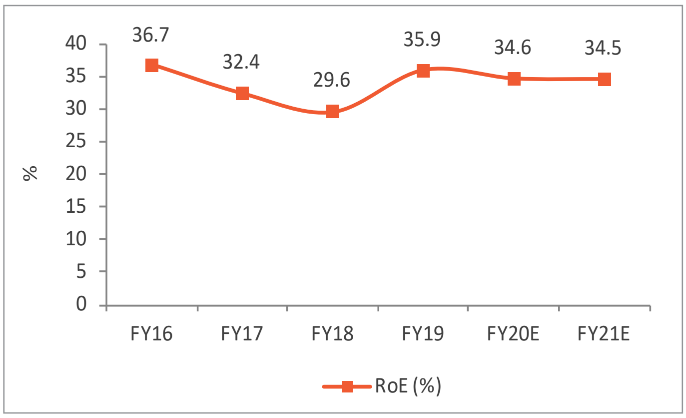
Source: Company, Sharekhan Research

Trend in digital revenue



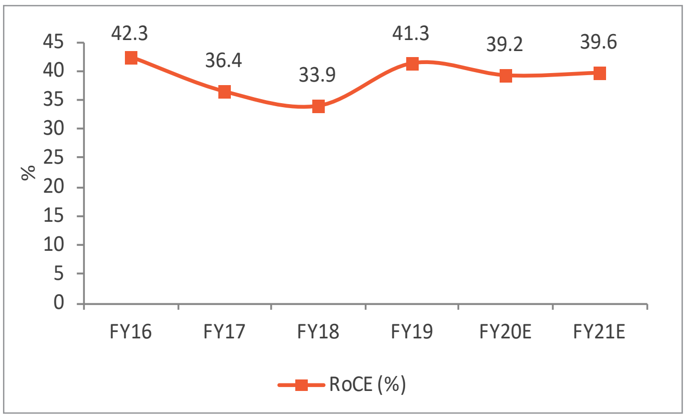
Source: Company, Sharekhan Research

RoE trend



Source: Company, Sharekhan Research

RoCE trend



Source: Company, Sharekhan Research

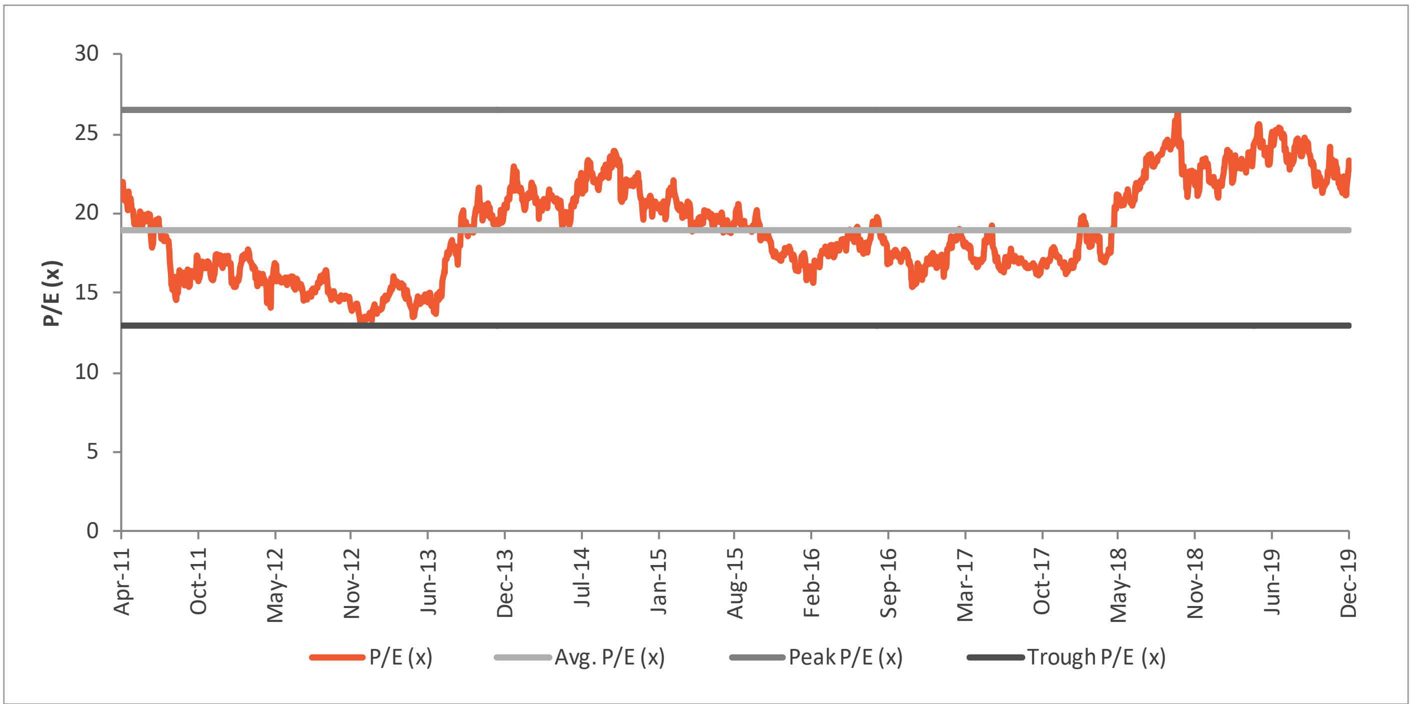
Outlook

Being the larger 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, TCS's 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. Management cited that growth of both the BFSI and retail verticals would continue to moderate in Q3FY2020E owing to continued weak spending in the capital market segment in the U.S. and large banks in Europe and delay in deal closures in the retail space.

Valuation

We expect TCS's CC revenue growth on a y-o-y basis would moderate in Q3FY2020E owing to slowdown in both the BFSI and retail verticals (together account for ~46% of total revenue) and higher impact furloughs. Further, leakage in existing/old projects and/or delay in decision making on spending programmes owing to uncertain macros and upcoming election could impact its growth in the near term. However, we continue to like TCS on account of strength in its business model, consistency, solid execution and strong FCF-generation profile. We have introduced FY2022E numbers in this note. At the CMP, the stock is trading at 25x/23x its FY2020E/FY2021E earnings, making risk-reward ratio unfavourable when demand is moderating. Hence, we downgrade our rating from Buy to Hold on the stock with a revised PT of Rs. 2,300.

One-year forward P/E (x) band



Source: Company; Sharekhan Research

Peer valuation

Particulars	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)		EV/EBIDTA (x)		P/BV (x)		RoE (%)	
				FY20E	FY21E	FY20E	FY21E	FY20E	FY21E	FY20E	FY21E
HCL Tech	571	271	1,54,968	15.3	13.7	9.5	8.5	1.7	1.5	23.1	23.0
Tech M	784	96	75,596	16.3	13.6	10.9	8.4	3.3	2.9	19.3	20.3
Wipro	252	571	1,43,737	15.0	13.6	9.2	8.0	3.1	2.8	17.8	17.4
TCS	2,223	375	8,33,986	25.5	23.3	19.7	178	8.4	7.7	34.6	34.5

Source: Company, Sharekhan estimates

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 relationship with customers, 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 broad range of capabilities, robust digital competencies, strong platform and stable management. The company is a 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 acceleration in deal wins with increasing TCVs, broad-based service offerings, higher budgets toward digital technologies and improving sales expertise.

Key Risks

1) Rupee appreciation and/or adverse cross-currency movement, 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

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 Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Tata Sons Pvt Ltd	72.02
2	Life Insurance Corp of India	3.98
3	BlackRock Inc	0.90
4	Vanguard Group Inc	0.89
5	First State Investments ICVC	0.79
6	JPMorgan Chase & Co	0.78
7	SBI Funds Management Pvt Ltd	0.70
8	Invesco Ltd	0.48
9	Standard Life Aberdeen PLC	0.44
10	Axis Asset Management Co Ltd	0.37

Source: Bloomberg

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