



3R MATRIX

	+	=	-
Right Sector (RS)	✓	✗	✗
Right Quality (RQ)	✓	✗	✗
Right Valuation (RV)	✓	✓	✗

+ Positive = Neutral - Negative

Reco/View

Reco/View	Change
Reco: Buy	↑
CMP: Rs. 2,324	
Price Target: Rs. 2,600	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

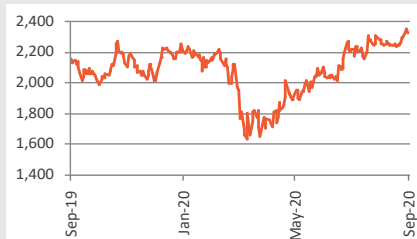
Company details

Market cap:	Rs. 871,960 cr
52-week high/low:	Rs. 2,389 / 1,504
NSE volume: (No of shares)	42.3 lakh
BSE code:	532540
NSE 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	1.8	10.2	18.9	7.9
Relative to Sensex	1.8	-1.3	11.9	5.4

Sharekhan Research, Bloomberg

Tata Consultancy Services

All-weather winner

IT & ITES

Sharekhan code: TCS

Stock Update

Summary

- We upgrade TCS to Buy from Hold with a revised PT of Rs. 2,600, given strong earnings growth potential over FY2021-23E
- Company best-placed to leverage next transformation wave given early investments on tech spend areas, strong delivery model, client proximity and status as preferred digital partner of large enterprises.
- Deal wins have been consistent despite COVID-led lockdown; deal TCVs at \$6.9 billion in Q1FY2021.
- We expect margins to improve in Q2 on the back of possible deferral of variable compensation, continued lower spends on travel & facilities and cancellation of marketing events.

TCS is a global IT services provider with a strong engineering heritage, wide-range of digital offerings and a marquee client base, strong platform bets and consistency in strategy. Hence, we believe TCS is best placed to leverage the next transformation wave given its early investments in capturing new tech spend areas, robust delivery model, client proximity and the preferred strategic digital partner of large enterprises. The managements of most IT companies also indicated higher spending on transformational works to improve business resiliency, emergence of new business models and cost-takeout initiatives. Indian IT services is expected to enter into a high-growth phase on the back of (1) higher core modernisation to build business resiliency, (2) shift to new business models and/or cost-takeout projects and (3) increase in online activities considering social distancing measures. We expect gradual recovery in TCS' revenue growth from Q2FY2021E given the absence of supply-side constraints, healthy technology spending outlook by BFSI vertical clients, surge in demand for digital infrastructure solutions and core modernisation. Further, TCS maintained consistency in strong deal wins in Q1FY2021 despite strict lockdown measures across major geographies, with deal TCVs of \$6.9 billion in Q1FY2021. Though TCS' EBIT margins lagged expectations owing to pricing pressures and a revenue decline which was in contrast to its large peers, we expect TCS' margins to improve sharply in Q2FY2021 led by possible deferral of variable compensation payouts, continued lower spending on travel and facilities and cancellation of marketing events.

Our Call

Valuation –Upgrade to Buy with a PT of Rs. 2600: We continue to prefer TCS on account of a strength in its business model, consistency, solid execution and strong free cash flows (FCF) generation. We introduced FY2023E numbers in this note. We believe that most uncertainties related to impact of demand environment in the wake of COVID-19 crisis have faded away with acceleration of tech spending on transformation. With an increase in adoption of online solutions across verticals and healthy technology spending outlook in BFSI space, we expect revenue and earnings would grow at 10.5%/11.5% CAGR over FY2021-23E. At CMP, the stock is trading at 25x/22x of its FY2022E/FY2023E earnings, which is justified given potential strong earnings growth, leadership in digital competencies and strong payout policy. We are ascribing a higher multiple to derive the price target because of an early up-cycle. Hence, we upgrade our rating on TCS to Buy from a Hold on the stock with a revised PT of Rs. 2,600.

Key Risks

Rupee appreciation and/or adverse cross-currency movements and/or constraint in local talent supply in the US and a stringent visa regime would impact earnings.

Valuation

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenue	146,463.0	156,949.0	157,910.8	174,785.7	192,806.2
OPM (%)	27.0	26.8	26.7	26.7	26.5
Adjusted PAT	31,472.0	32,340.0	31,331.2	35,180.0	38,956.7
% y-o-y growth	21.9	2.8	-3.1	12.3	10.7
Adjusted EPS (Rs.)	83.1	86.2	83.5	93.8	103.8
P/E (x)	28.0	27.0	27.8	24.8	22.4
P/B (x)	9.7	10.3	10.5	10.8	10.5
EV/EBITDA (x)	21.8	20.7	20.8	18.8	17.2
RoNW (%)	35.9	37.0	37.4	43.0	47.7
RoCE (%)	41.3	41.0	40.6	46.4	50.9

Source: Company; Sharekhan estimates

Technology intensity rising steadily

Implications from the COVID-19 outbreak have accelerated digital activities among large global enterprises, leading to a rise in spending on workplace transformation and collaboration tools, cybersecurity and higher cloud migration. As technology is seen as a source of competitive differentiation in every industry and we believe that technology spend is expected to increase once the situation normalises. Further, higher online activity is driving higher technology spends in developed markets, which would drive outsourcing growth in India as the Indian IT industry has remained far more resilient as compared to global competitors and captive units of large enterprises and talent diversity.

Industry analysts have estimated the IT services spending growth to decline by 2-10% for CY2020 and subsequent recovery in CY2021. IT companies' managements indicated a rise in demand for digital engagement among large enterprises, though they also acknowledged reduction in discretionary spends and spends in core businesses in the nearterm and a cut in technology budgets of directly impacted verticals. Despite a recessionary environment, most managements of IT companies also indicated higher spending on transformational works to improve business resiliency, emergence of new business models and cost-takeout initiatives. The Indian IT services sector is expected to enter into high-growth phases on the back of (1) higher core modernisation to build business resiliency, (2) higher cloud adoption and (3) increase in online activities considering social distancing measures.

TCS well-suited to ride next transformation wave

In our view, TCS will be one of the biggest beneficiaries from the upcoming transformation wave considering delivery excellence model, well-rounded portfolio of practices, industry expertise, early investments in capturing new tech spend areas, enviable scale, resilient processes and strong relationships with clients. In response to lockdown restrictions in major markets, TCS has switched to the extreme form of distributed delivery (448,000 employees enabled to work remotely) from a highly centralised model (of delivery from campuses) in a short time. The company's investments in open agile workplaces helped it to switch quickly to this new Secure Borderless Workspace (SBWS) delivery model during the COVID-19 lockdown. Using SBWS, TCS has been able to support its customers in critical operations as well as transformational projects with nil slippages.

Demonstrated ability to win large deals during travel restrictions

TCS has demonstrated its ability by signing a large deal virtually during Q1FY2021. The company believes more and more activities including the sale process will go virtual post the pandemic. Further, ramp-ups on some of the large deals won in last two quarters are progressing smoothly. This has reduced transmission losses and made the process more efficient.

Expect margins improvement in the near-term

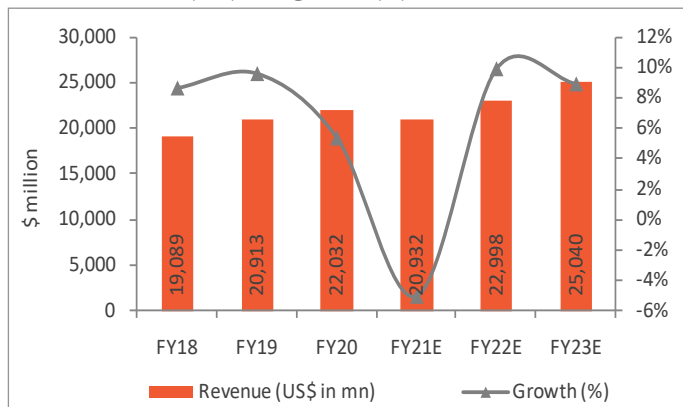
We believe work-from-home (WFH) efficiencies, lower travel costs are expected to drive margins in near-term, however, it will be passed on to clients through pricing reduction in the long term. TCS' EBIT margins were marginally below expectations owing to pricing pressure and revenue decline, while its large peers did better in terms of margin execution. We believe that TCS did not use its variable compensation lever to arrest the fall in margins. The management indicated that cost management at the granular business unit level, managed services contract, machine-first delivery model and replacing subcontractors with its employees would help the company for margin improvement. Further, the management expects 75% of its workforce would shift to WFH model permanently by 2025E, which could drive margin benefits because of lower operating expenses on facility management. We expect improvement in margins for TCS in Q2FY2021 on the back of deferral of variable compensation, lower spending on travel and facilities and cancellation of marketing events.

Revenue growth to recover; Consistent in quarterly deal wins

We expect TCS' revenue growth to recover from Q2FY2021E given the absence of supply-side constraints, healthy technology spending outlook by BFSI clients, a surge in demand for digital infrastructure solutions and core modernisation. TCS would be benefited from three broad spending themes by customers – (1) Smart secure workplace and collaboration – many customers have been investing in implementing more secure workplace and collaboration tools; (2) customer experience – there are sharp changes in customer behaviour due to this pandemic. As customers are moving to an 'online-only' mode, it has been triggering a lot of investment on front-end transformation, customer experience enhancement, etc and (3) core transformation – the pandemic highlighted the need of operational resilience and agility within the enterprise. Strong deal wins continued in Q1FY2021, with deal TCVs of \$6.9 billion (versus \$8.9 billion in Q4FY2020). Deal pipeline remains balanced in terms of size and speed, while actual deal closure remained polarised.

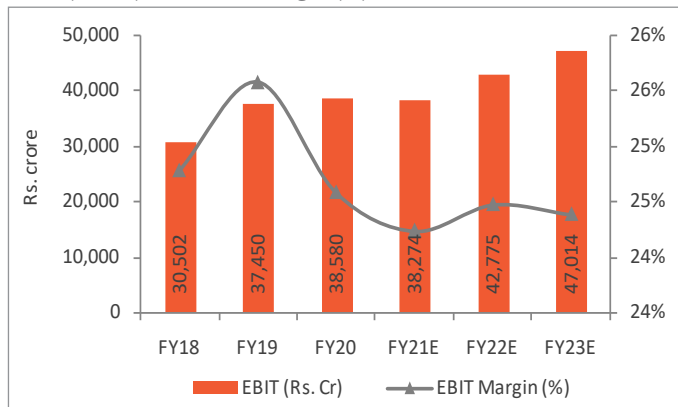
Financials in charts

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



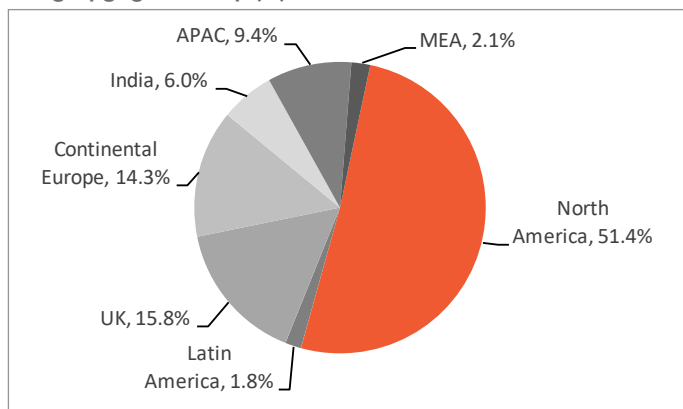
Source: Company, Sharekhan Research

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



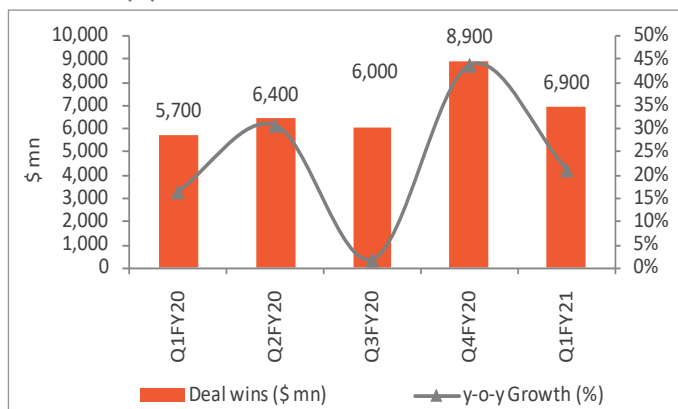
Source: Company, Sharekhan Research

Geography break-up (%)



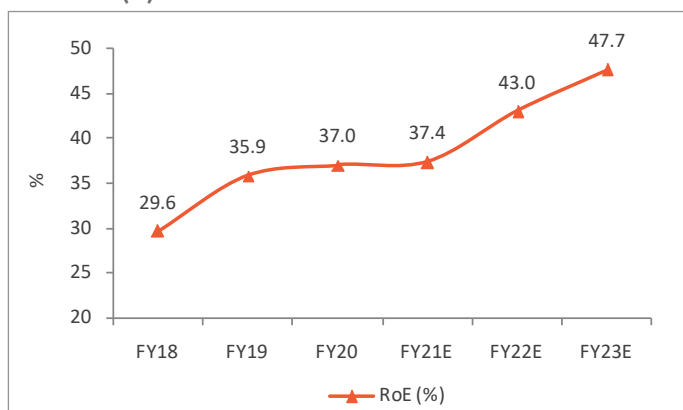
Source: Company, Sharekhan Research

Deal wins (%)



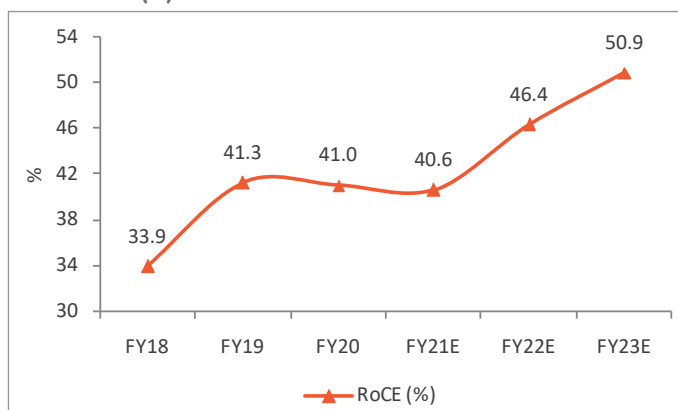
Source: Company, Sharekhan Research

RoE trend (%)



Source: Company, Sharekhan Research

RoCE trend (%)



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector view - Expect acceleration in technology spending going forward

Industry analysts such as Gartner estimates IT services spending would grow by 5-8% over CY2021-24E as compared to an average of 4.2% achieved in CY2010-19. Forecasts indicate higher demand for cloud infrastructure services, potential increase in specialised software, potential investments in transformation projects by clients and increase in online adoption across verticals. Implications of the COVID-19 outbreak have accelerated digital activities among large global enterprises, leading to an increase in spending on workplace transformation and collaboration tools, cyber-security and higher cloud migration. We believe that the variable cost structure of companies combined with cost-efficiency measures would help the IT companies to absorb pricing pressure and increase in administrative expenses (post normalcy) to some extent.

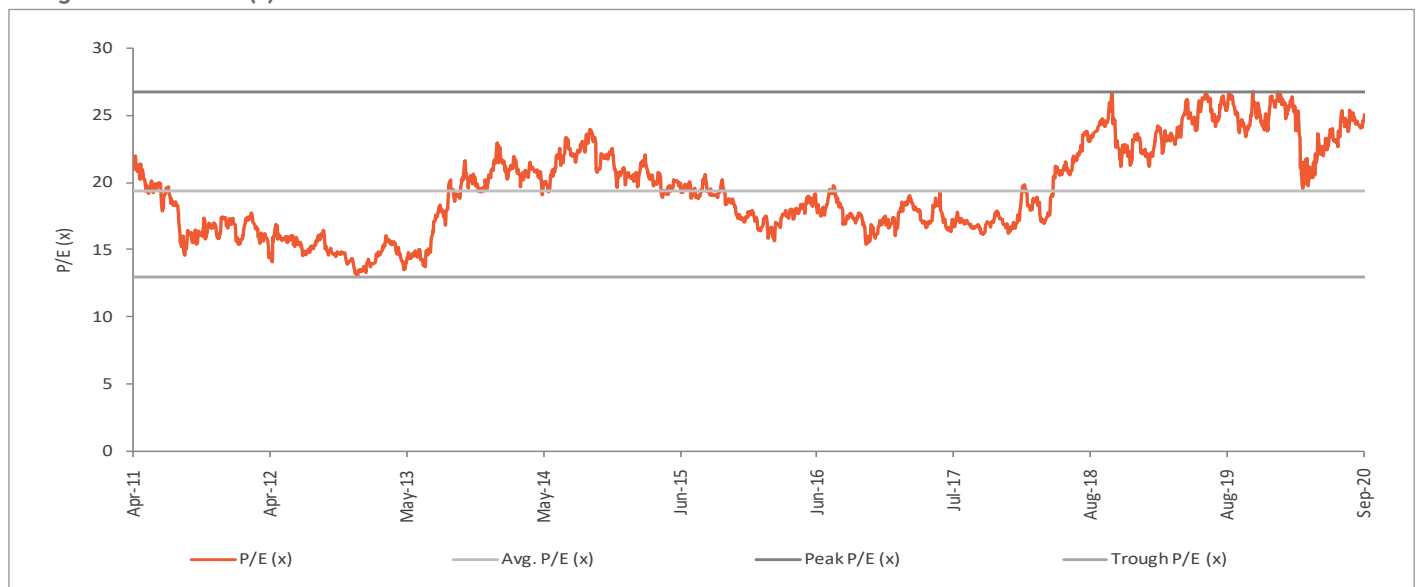
■ Company outlook - a dominant position

Being one of the largest IT services companies worldwide and preferred partners of clients, TCS has the ability to capture a substantial portion of spends on digital technology and is well-positioned to capitalise on opportunities as and when clients boost technology expenditure. Further, the company is well-placed from a competitive perspective, especially in newer technologies. A stable management and the ability to structure large multi-service deals would help TCS recover once the situation normalises. The management intends to keep the payout ratio at 80-100% of free-cash generated.

■ Valuation - Cross-cycle champion

We continue to prefer TCS on account of a strength in its business model, consistency, solid execution and strong free cash flows (FCF) generation. We introduced FY2023E numbers in this note. We believe that most uncertainties related to impact of demand environment in the wake of COVID-19 crisis have faded away with acceleration of tech spending on transformation. With an increase in adoption of online solutions across verticals and healthy technology spending outlook in BFSI space, we expect revenue and earnings would grow at 10.5%/11.5% CAGR over FY2021-23E. At CMP, the stock is trading at 25x/22x of its FY2022E/FY2023E earnings, which is justified given potential strong earnings growth, leadership in digital competencies and strong payout policy. We are ascribing a higher multiple to derive the price target because of an early up-cycle. Hence, we upgrade our rating on TCS to Buy from a Hold on the stock with a revised PT of Rs. 2,600.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer valuation

Particulars	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)		EV/EBITDA (x)		P/BV (x)		RoE (%)	
				FY21E	FY22E	FY21E	FY22E	FY21E	FY22E	FY21E	FY22E
HCL Tech	723	271	196,062	17.1	15.5	5.4	5.0	3.4	3.1	21.2	21.1
Wipro	283	571	161,577	16.4	15.6	4.4	3.9	2.8	2.6	15.6	15.5
TCS	2,324	375	871,960	27.8	24.8	20.8	18.8	10.5	10.8	37.4	43.0

Source: Company, Sharekhan Research

About company

TCS is among the pioneers of IT services outsourcing business in India and is the largest (\$22,032 million revenue in FY2020) 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

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	Life Insurance Corporation of India	4.22
2	JPMorgan Chase & Co.	1.01
3	Vanguard Group Inc.	0.90
4	Invesco Ltd.	0.81
5	First State Investments ICVC	0.78
6	SBI Funds Management Pvt. Ltd.	0.78
7	BlackRock Inc.	0.72
8	First State Global Umbrella Fund P	0.51
9	Axis Asset Management Co. Ltd.	0.49
10	Standard Life Aberdeen PLC	0.38

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and deteriorating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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