Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)		✓	

\+ Positive = Neutral – Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

ESG Disclosure Score NEW

ESG RISK RATING Updated Jan 08, 2021				14.25
Low Risk				
NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

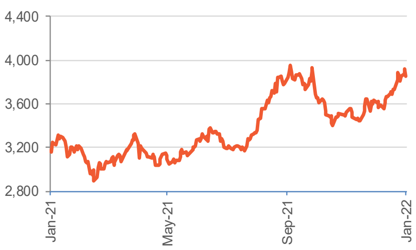
Company details

Market cap:	Rs. 14,26,817 cr
52-week high/low:	Rs. 3,990 / 2,701
NSE volume: (No of shares)	24.5 lakh
BSE code:	532540
NSE code:	TCS
Free float: (No of shares)	102.9 cr

Shareholding (%)

Promoters	72.2
FII	15.5
DII	8.2
Others	4.1

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	6.8	5.5	21.0	21.6
Relative to Sensex	1.9	4.8	5.1	-1.9

Sharekhan Research, Bloomberg

Tata Consultancy Services

Mixed quarter, well-poised to capture opportunities

Stock Update

IT & ITES	Sharekhan code: TCS
Reco/View: Buy ↔	CMP: Rs. 3,857
Price Target: Rs. 4,600 ↑	

↑ Upgrade ↔ Maintain ↓ Downgrade

Summary

- Q3FY2022 revenue growth beat our estimates but margins lagged expectations. Deal wins, client additions, fresher hiring and cash conversion stayed strong.
- Strong demand was led by (1) higher investments in building digital core, (2) technology and operation optimisation and (3) growth & transformation agenda. TCS is well-equipped to capture market opportunities.
- The company announced a buy-back of Rs. 18,000 crore at Rs. 4500/share, implying a premium of 16.7%. The quantum of the buyback is higher than its last three buyback programs.
- We continue to prefer TCS on account of its full-service business model, solid execution, a large talent pool, higher payouts to shareholders and a robust client base. Hence, we maintain a Buy with a revised PT of Rs. 4,600.

TCS reported better-than-expected revenue performance led by strong growth in retail and CPG, manufacturing and regional market verticals, while EBIT margins lagged expectations owing to rising expenses for backfilling attrition and higher discretionary expenses. Constant currency (CC) revenue grew by 15.5% y-o-y in Q3FY2022 compared to 21.5% y-o-y for Infosys and 28.5% y-o-y for Wipro. TCS' Board approved a buyback of 1.08% of paid-up equity (4.0 crore equity shares) at Rs. 4,500 per share, implying total return of Rs. 18,000 crore to shareholders. The quantum of the buyback is higher to its last three buyback programs. Cash conversion remained strong with operating cash flow (OCF) to net income ratio at 111% (versus 103% in Q2FY2022).

Key positives

- Net headcount addition of 28,238 was strong. Further, it added 34,000 freshers in Q3FY2022.
- Signed healthy deal TCVs of $7.6 billion, up 12% y-o-y.
- Expect uptick in pricing in current environment

Key negatives

- Margins contracted 60 bps to 25%, owing to supply-side challenges
- Attrition inched up 340 bps q-o-q to 15.3%

Management Commentary

- Management cited that pricing is stable with an upward bias.
- The company doesn't expect any reduction in clients' IT budgets in CY2022. Thus, demand to stay strong.

Revision in estimates – We tweaked our earnings estimates for FY22E/ FY23E/FY24E EPS on the back of revenue beat and higher discretionary spending.

Our Call

Valuation – Maintain Buy with a PT of Rs. 4,600: We believe TCS is well-positioned to capture market opportunities, given its competencies across technologies and industries, strong contextual knowledge, mature product & platform portfolio and solid execution capabilities. We expect the company's US Dollar revenue and earnings to clock an 11%/15% CAGR over FY2022-24E. At CMP, stock trades at valuation of 32x/28x its FY2023E/FY2024E earnings, which is justified given strong revenue growth potential, superior margin profile, healthy deal TCVs and a large talent pool. Hence, we maintain a Buy on TCS with a revised PT of Rs. 4,600.

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 affect earnings.

Valuation (Consolidated) Rs cr

Particulars	FY21	FY22E	FY23E	FY24E
Revenue	1,64,177.0	1,91,077.9	2,18,234.5	2,44,368.4
OPM (%)	28.4	27.7	28.2	28.3
Adjusted PAT	33,388.0	38,384.5	44,637.4	50,841.5
% y-o-y growth	*3.2*	*15.0*	*16.3*	*13.9*
Adjusted EPS (Rs.)	89.3	103.7	120.7	137.5
P/E (x)	43.2	37.2	32.0	28.1
P/B (x)	16.6	16.0	15.6	15.2
EV/EBITDA (x)	30.0	26.4	22.7	20.2
RoNW (%)	38.9	43.6	49.5	54.9
RoCE (%)	65.3	67.1	69.9	71.3

Source: Company; Sharekhan estimates

Mixed quarter- revenue beat, margins missed estimates

TCS reported better-than-expected revenue performance on the back of strong demand for growth & transformation (G&T) projects, higher spends on digital technologies and accelerated shift to Cloud. Constant currency (CC) revenue grew by 4% q-o-q and 15.5% y-o-y, led by broad-based growth across key verticals. Revenue in US Dollar terms grew by 3%/14.4% q-o-q/y-o-y to $6,524 million. EBIT margin declined 60 bps q-o-q to 25% owing to a 70-bps impact from higher subcontractor expenses, targeted increments and rising expenses for backfilling attrition and a 60 bps impact due to higher discretionary expenses (travel, marketing and facility expenses). These margin headwinds were partially offset by operational efficiencies, better realisations and improving utilisation. Net profit stood at Rs. 9,769 crore (up 1.5% q-o-q and 12.3% y-o-y) and was in line with our estimates. We note that net employee additions, client additions and cash conversion remained strong. Cash conversion remained strong with operating cash flow (OCF) to net income ratio at 111% (versus 103% in Q2FY2022).

Capital allocation through buyback and dividends

TCS' Board approved the buyback of 1.08% of paid-up equity (~4.0 crore shares) at Rs. 4,500, implying total return of Rs. 18,000 crore to its shareholders. The quantum of the buyback is higher to its last three buyback programs. This amounts to ~27% of the company's Rs. 66,985 crore cash balance and ~17% of net worth. This buyback alone implies a payout of ~47% on our FY2022 PAT estimate and 54% of FY2022 FCF estimates. The buyback should result in slight accretion to EPS from a reduction in share count. However, the cash reduction would result in a decline in other income.

Small shareholders owning shares worth Rs 2 lakh or less as on the record date will get reservation in the buyback offers to the extent of 15% of the buyback size. The reservation for these shareholders would be Rs 2,700 crore (0.6 crore shares at price of Rs. 4500/share). As per the distribution of shareholding available, 875,220 shareholders (holding up to 100 shares) have 2.23 crore shares. Most small shareholders do not take part in such offers, which would result in a higher acceptance ratio (in the last three instances, the acceptance ratio was 100%). However, the theoretical retail entitlement ratio stands at 25-30%. TCS is buying back shares at a premium of ~16.7% to the current price of ~Rs 3,857 per share. Investors looking for a short-term opportunity can buy shares (up to a value of Rs. 2 lakh) in the open market and offer them in the tender offer. Moreover, the company has declared an interim dividend of Rs. 7 per equity share.

Buyback History

TCS	2017	2018	2020	2021
Announcement date	Feb 16, 2017	Jun 12, 2018	Oct 7, 2020	Jan 7, 2022
Buyback Size (Rs. Cr)	16,000	16,000	16,000	18,000
Number of Shares (Cr.)	5.61	7.62	5.33	4.00
% Of Shareholding	2.85%	1.99%	1.42%	1.08%
Buy Back Price (Rs.)	2,850	2,100	3,000	4,500
Price on announcement date	2,340	1,743	2,523	3,855
Premium (%)	21.8%	20.5%	18.9%	16.7%
Record date	May 8, 2017	Aug 18, 2018	Nov 28, 2020	-
Days taken	81	67	52	-
Reserved for small shareholders (cr.)	0.84	1.14	0.80	-
Shares validly tendered (cr.)	0.42	0.40	0.61	-
Final acceptance ratio for retail	**100.0%**	**100.0%**	**100.0%**	-

Source: Company; Sharekhan Research

Key result highlights

- **Strong demand outlook:** Strong demand has been driven by (1) increase the investments in building a digital core, (2) technologies and operation optimisation and (3) Growth & Transformation agenda. As organisations have been focusing on optimising operations to support its transformation program, it has resulted in rising spends on technologies. We believe the company's proactive investments in capability building, client relationships and talent would help it capture opportunities from digital, cloud and G&T initiatives of customers. Given its end-to-end capabilities, strong contextual knowledge and excellent product and platform offerings, we believe that TCS will be at the forefront of accelerating clients' growth and transformation initiatives.

- **Cloud transformation deals:** The management stated that Horizon 1, 2 and 3 deals are prime drivers of multi-year technology cycle. Horizon 1 is cloud migration which is currently playing out across the globe and it is time bound. Horizon 2 deals are more cloud native capabilities which will be leveraged to transform the company's core. Horizon 3 is an ecosystem play, where TCS plans to capture the maximum opportunities.
- **Price hikes:** The management cited that pricing is stable with an upward bias. There are some price increases in current quarter and management expects increase in pricing in the coming quarters.
- **Expectations on clients' budget for CY2022:** The management doesn't experience any reduction in client budgets in CY2022. Hence, it believes that strong demand environment is likely to sustain in coming years.
- **Strong product & platform portfolio:** TCS continued to witness strong traction in its product and platform portfolio. Ignio, a cognitive automation solution platform, acquired 10 (versus 22 in Q2FY22) new logos during the quarter and 5 (versus 8 in Q2FY22) customers' 'go-lives' on the product. TCS BaNCS, its flagship product in the financial services domain, had nine new wins during the quarter and five 'go-lives' on the product. Quartz had three new wins during the quarter and is being leveraged across use cases such as mobile payments, issuance of bank guarantees, internet borrowings, etc. TCS ADD, its comprehensive suite for digital transformation of drug development and clinical trials, is now live at Amgen (one of the world's leading biotech companies). TCS HOBS, plug & play SaaS-based business platform to digitally transform businesses had two 'go-lives' on the product. TCS Omnistore and TCS MasterKraft had 2 and 24 new wins, respectively during the quarter
- **Strong headcount addition continued, attrition inched up:** The company's headcount stood at 5,56,986, a net addition of 28,238 employees q-o-q. Net employee additions remained strong for fifth consecutive quarter. The company added 103,446 net employees in the past five quarters, which was 22.8% of Q2FY2021 the total headcount. The management highlighted that TCS recruited 43,000 fresher during H1FY2022 and 34,000 freshers in Q3FY2022. The company indicated that it will hire some more fresher in Q4FY2022. Attrition rate at 15.3% remained the lowest in the industry, but it increased significantly 340 bps q-o-q. The management expects that attrition would stay high in the next 2-3 quarters owing to a strong demand environment. Management indicated that churn in attrition is stabilizing for now, however it may increase in Q4FY2022 due to the last twelve-month (LTM) calculation. We believe the company's robust talent retention model is expected to help it to overcome supply-side concerns. TCS intends to maintain hiring pace in FY2023 as it wants to keep supply ready to meet the ongoing strong demand environment and anticipated higher attrition.
- **Cash generation remained strong:** Operating cash flows increased by 9% to Rs. 10,853 crore, which was 111% to net profit. The company's free cash flow (FCF) stood at Rs. 9,943 crore, down 11.5% y-o-y. Cash conversion remained strong with the FCF/EBITDA ratio at 74%. Total cash & investments stood at Rs. 66,985 crore during the quarter versus Rs. 60,548 crore in Q2FY2022. The Board has recommended an interim dividend of Rs. 7 per share (vs Rs. 14 in H1FY2022).
- **Large deal wins remained broad-based:** TCS highlighted that deal wins were broad-based across the industries. The mix of deals in pipeline remains across sizes. The management indicated that it is well placed to participate across all emerging opportunities including digital, cloud transformation, design and product developments. Healthy deal wins continued in Q3FY2022, with TCVs of $7.6 billion. Deal wins TCVs increased by 12% y-o-y but remained flattish on q-o-q. The book-to-bill ratio during the quarter remained at 1.16x in Q3FY2022 versus 1.2x in Q2FY2022. TCS signed deals worth $4.5 billion in North America, $2.5 billion in the BFSI vertical and $1 billion in the retail vertical.

Results Rs cr

Particulars	Q3FY22	Q3FY21	Q2FY22	Y-o-Y %	Q-o-Q %
Revenue ($ mn)	**6,524.0**	**5,702.0**	**6,333.0**	**14.4**	**3.0**
Revenue in INR (cr)	**48,885.0**	**42,015.0**	**46,867.0**	**16.4**	**4.3**
Direct costs	28,401.0	23,749.0	27,048.0	19.6	5.0
Gross profit	**20,484.0**	**18,266.0**	**19,819.0**	**12.1**	**3.4**
SG&A	7,051.0	6,059.0	6,704.0	16.4	5.2
EBITDA	**13,433.0**	**12,207.0**	**13,115.0**	**10.0**	**2.4**
Depreciation	1,196.0	1,023.0	1,115.0	16.9	7.3
EBIT	**12,237.0**	**11,184.0**	**12,000.0**	**9.4**	**2.0**
Other income	954.0	508.0	969.0	87.8	-1.5
PBT	13,191.0	11,692.0	12,969.0	12.8	1.7
Tax provision	3,385.0	2,965.0	3,316.0	14.2	2.1
Net profit	**9,806.0**	**8,727.0**	**9,653.0**	**12.4**	**1.6**
Minority interest	37.0	26.0	29.0	42.3	27.6
Adj. Net Profit	**9,769.0**	**8,701.0**	**9,624.0**	**12.3**	**1.5**
EPS (Rs.)	**26.4**	**23.2**	**26.0**	**13.9**	**1.5**
Margin (%)				**BPS**	**BPS**
EBITDA	27.5	29.1	28.0	-158	-50
EBIT	25.0	26.6	25.6	-159	-57
NPM	20.0	20.7	20.5	-73	-55
Tax rate	25.7	25.4	25.6	30	9

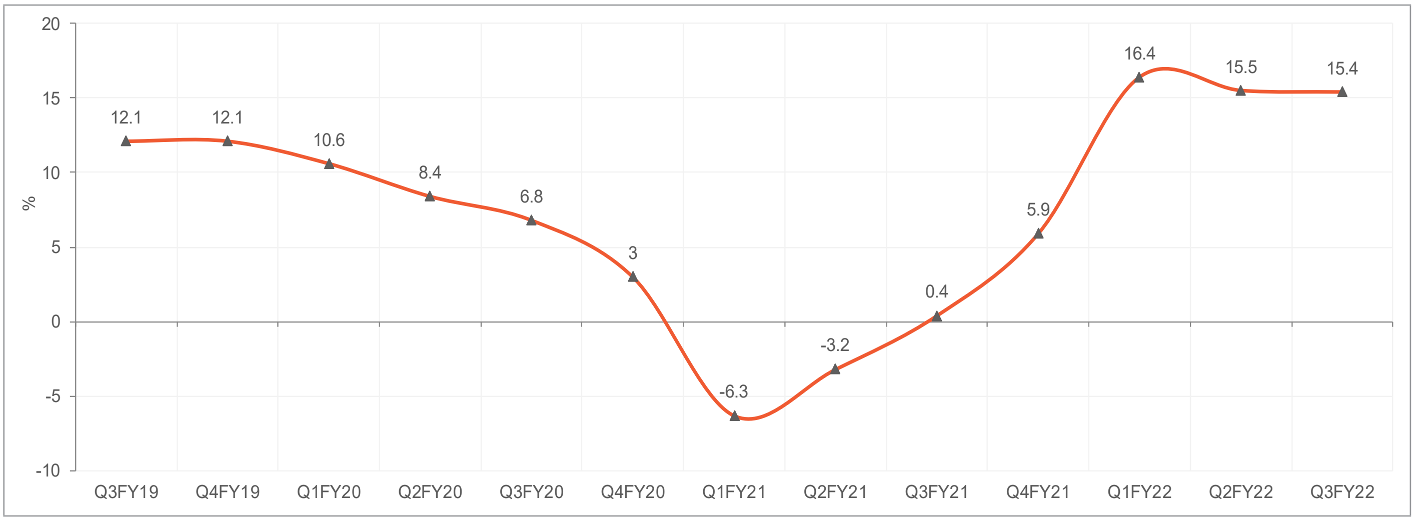
Source: Company; Sharekhan Research

Operating metrics

Particulars	Revenue ($ mn)	Contribution (%)	$ Growth (%)		CC growth (%)
			Q-o-Q %	Y-o-Y %	Y-o-Y %
Revenue ($ mn)	6,524	100	3.0	14.4	15.4
Geographic mix					
North America	3,308	50.7	3.8	18.1	18.0
Latin America	111	1.7	9.5	14.4	21.1
U.K.	1,018	15.6	-0.2	13.7	12.7
Continental Europe	1,044	16.0	3.7	13.0	17.5
India	359	5.5	11.1	12.4	15.2
APAC	561	8.6	-1.6	1.4	4.3
MEA	124	1.9	-2.1	8.7	6.9
Industry verticals					
BFSI	2,094	32.1	2.1	17.3	17.9
Retail & CPG	985	15.1	3.7	19.2	20.4
Communication & media	424	6.5	3.0	12.7	16.3
Manufacturing	646	9.9	3.0	18.0	18.3
Life Science and healthcare	646	9.9	2.0	15.6	17.7
Technology & services	568	8.7	1.8	15.7	14.4
Regional markets and others	1,161	17.8	5.4	3.9	5.2

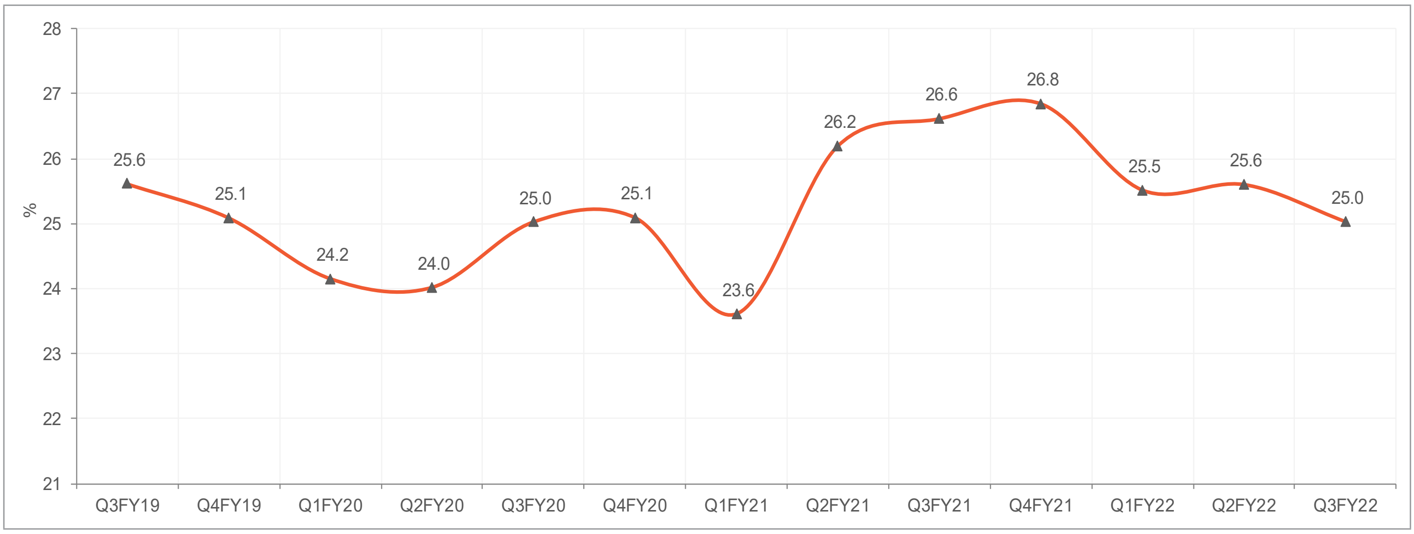
Source: Company; Sharekhan Research

TCS' constant-currency revenue growth (y-o-y) stays strong



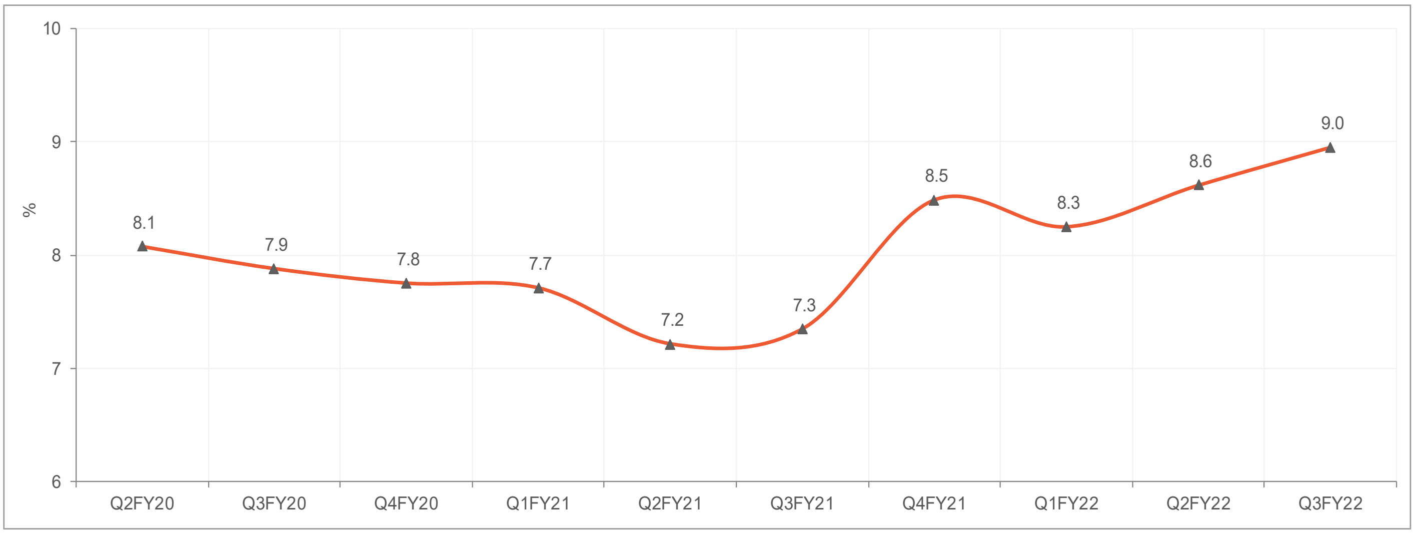
Source: Sharekhan Research

EBIT margin declined due to supply-side challenges



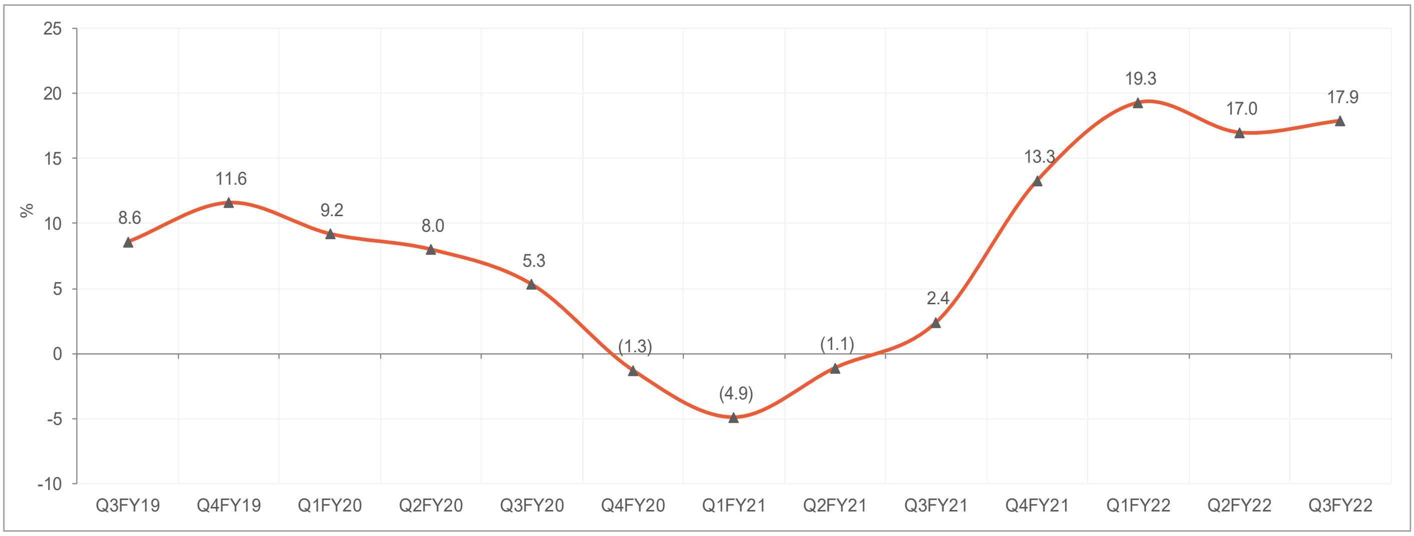
Source: Sharekhan Research

Subcontracting costs as % of revenue inched up



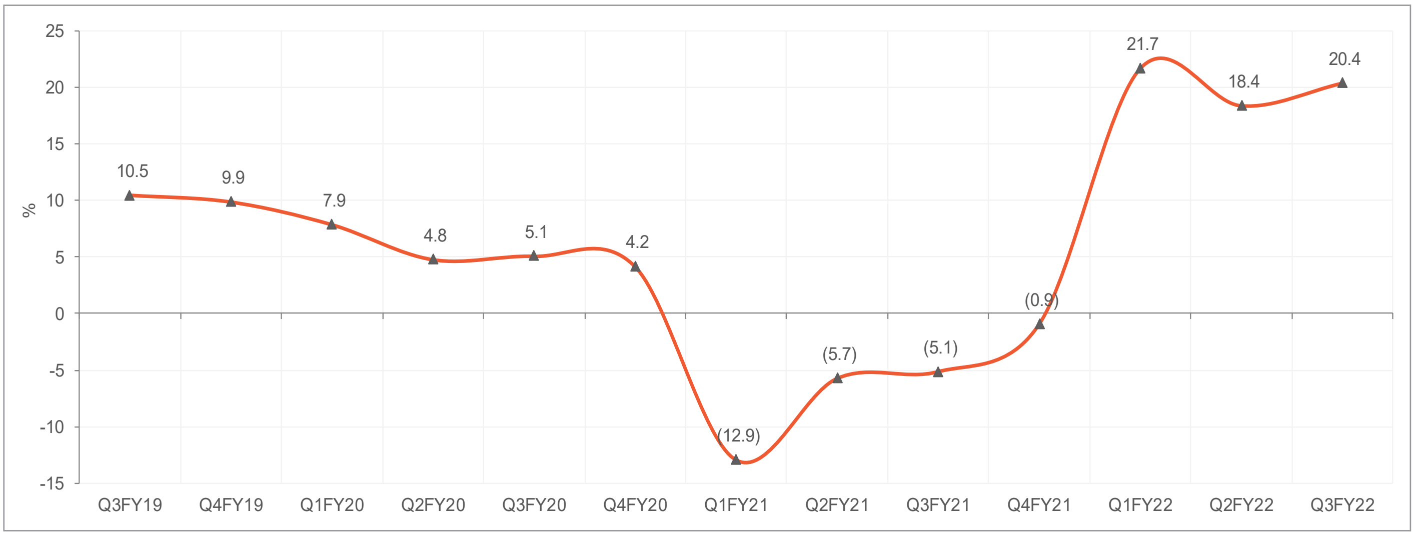
Source: Sharekhan Research

BFSI revenue growth remained strong



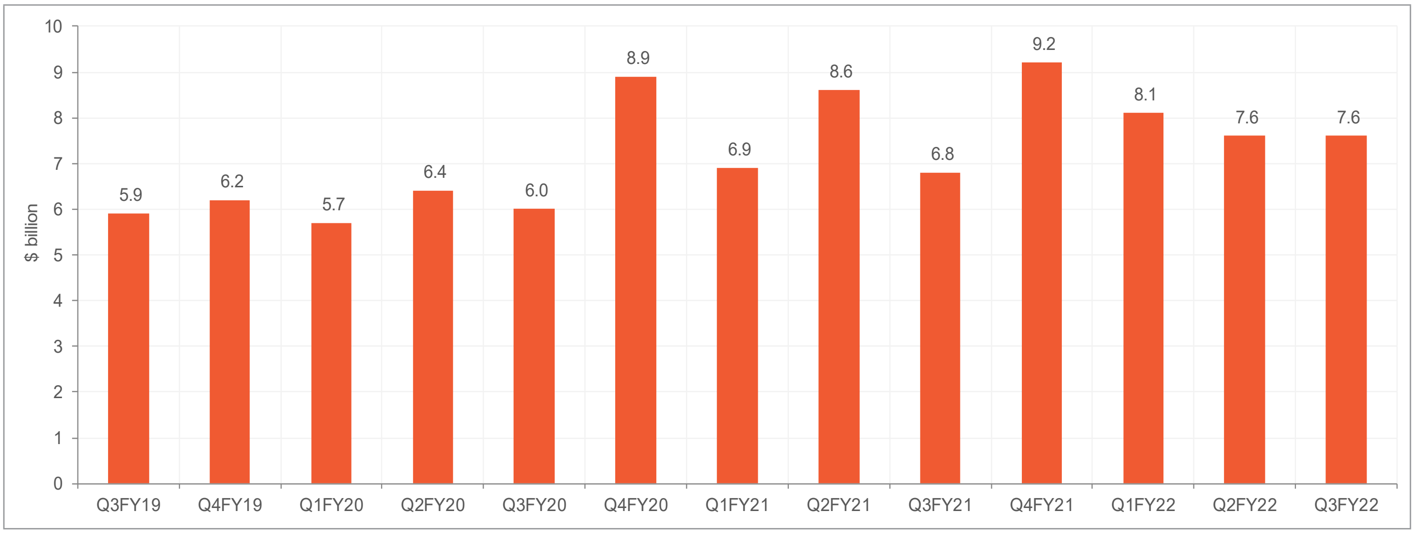
Source: Sharekhan Research

Strong growth in retail vertical continues



Source: Sharekhan Research

Healthy deal TCVs, in-line with average deal TCVs of last eight quarters



Source: Sharekhan Research

Outlook and Valuation

■ Sector view – Expect acceleration in technology spending going forward

We believe that the need for business continuity, operational resilience, and the switch to digital transactions have led to strong demand for IT services post the pandemic. Industry analysts such as Gartner estimate that IT services spending would grow by 8-8.5% in the next four years as compared to the average of 4.3% achieved over 2016-20. Forecasts indicate higher demand for cloud infrastructure services, a potential increase in specialised software, potential investments in transformation projects by clients, and increased online adoption across verticals.

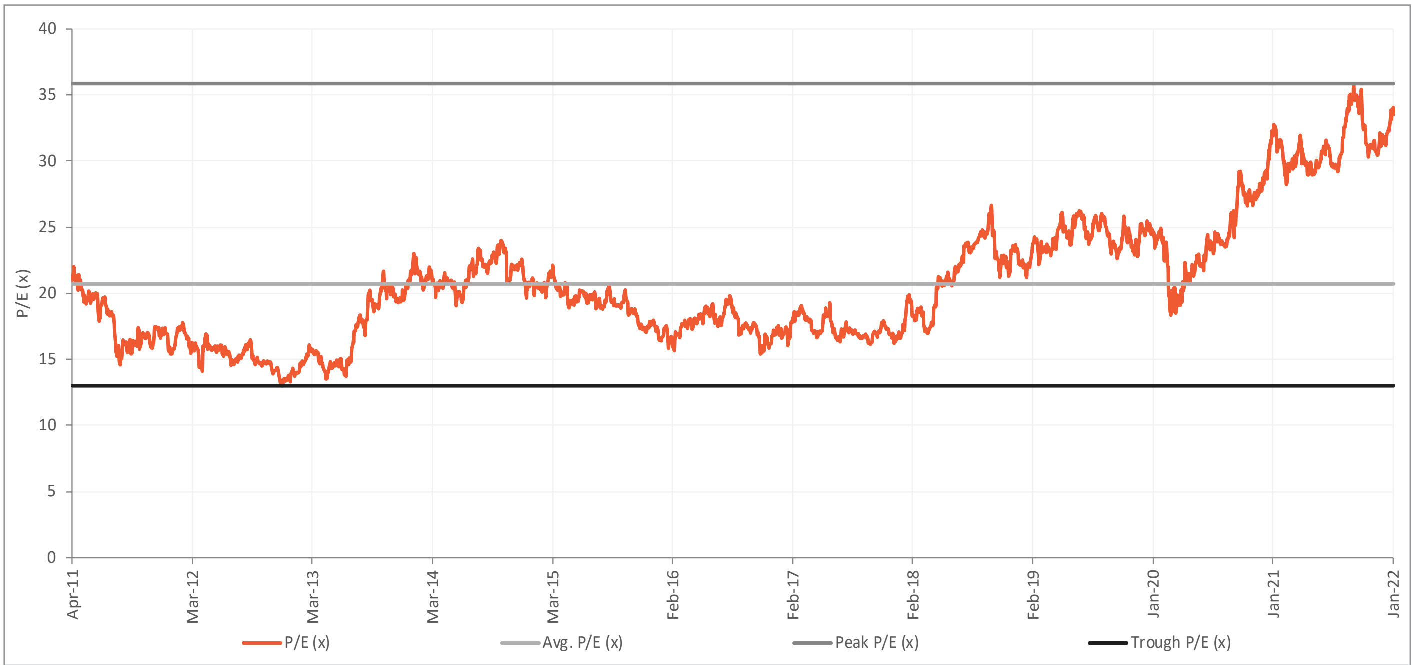
■ Company outlook – Staying ahead of the race

Being one of the largest IT services companies worldwide and having preferred partners as clients, TCS can capture a fair share of spends on digital and cloud transformation initiatives and is well-positioned to participate in clients' transformation journeys. Further, the company is well-placed from a competitive perspective, especially in newer technologies. A stable management, full-service capabilities, the ability to structure large multi-service deals and multi-horizon transformation demand would help TCS to deliver strong revenue growth in the next three years. The management intends to keep the payout ratio at 80-100% of free cash generated.

■ Valuation – Maintain Buy with a revised PT of Rs. 4,600

We believe TCS is well-positioned to capture market opportunities, given its competencies across technologies and industries, strong contextual knowledge, mature product & platform portfolio and solid execution capabilities. We expect the company's US Dollar revenue and earnings to clock an 11%/15% CAGR over FY2022-24E. At CMP, stock trades at valuation of 32x/28x its FY2023E/FY2024E earnings, which is justified given strong revenue growth potential, superior margin profile, healthy deal TCVs and a large talent pool. Hence, we maintain a Buy on TCS with a revised PT of Rs. 4,600.

One-year forward P/E (x) band



Source: Sharekhan Research

About company

TCS is among the pioneers of IT services outsourcing business in India and is the largest ($22,174 million revenue in FY2021) 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 strong deal wins, broad-based service offerings, higher spend on digital technologies and best-in-class execution.

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
Samir Seksaria	Chief Financial Officer
Milind Lakkad	EVP and Global Head, HR

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Life Insurance Corporation of India	3.67
2	Vanguard Group Inc.	1.04
3	BlackRock Inc.	0.85
4	SBI Funds Management Pvt. Ltd.	0.83
5	Invesco Ltd.	0.81
6	JPMorgan Chase & Co.	0.69
7	Axis Asset Management Co. Ltd.	0.63
8	First State Investments ICVC	0.44
9	FMR LLC	0.32
10	ABRDN PLC	0.31

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 detoriating 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

Sharekhan

by BNP PARIBAS

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