Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Tata Consultancy Services Ltd

Mixed Q3

IT & ITES	Sharekhan code: TCS
Reco/View: Buy ↔	CMP: Rs. 3,320	Price Target: Rs. 3,650 ↔

↑ Upgrade ↔ Maintain ↓ Downgrade

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 13.77

Updated Oct 08, 2022

Low Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

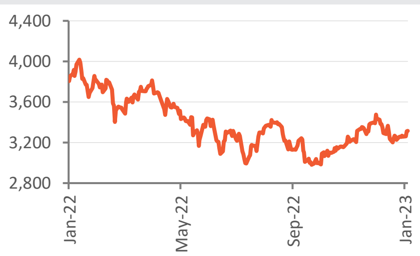
Company details

Market cap:	Rs. 12,14,805 cr
52-week high/low:	Rs. 4,046 / 2,926
NSE volume: (No of shares)	20.0 lakh
BSE code:	532540
NSE code:	TCS
Free float: (No of shares)	101.4 cr

Shareholding (%)

Promoters	72.3
FII	13.1
DII	8.5
Others	6.1

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	0.8	8.3	1.7	-13.9
Relative to Sensex	3.1	3.9	-9.8	-15.6

Sharekhan Research, Bloomberg

Summary

- Revenues grew by 2.2% q-o-q and 13.5% y-o-y in CC terms, ahead of our and street expectations of 1.5% q-o-q CC growth in a seasonally weak quarter, driven by cloud services, market share gains through vendor consolidation, and continued momentum in North America and U.K.
- EBIT margin improved by 50 bps to 24.5%,in line with street estimates led by currency benefits and better execution but offset by third party costs and return to normalcy costs. Management has guided for 25% exit margin for FY23.
- For the immediate near-term management commentary on geographies indicated varying levels of uncertainty due to the persisting macro-overhang. However, they have indicated greater confidence with respect to US and even UK while in case of Europe they are indicating caution for the medium term.
- At the current juncture, owing to multiple global headwinds outlook for FY24E looks uncertain, and recovery could be gradual in the coming quarters. However, we believe the structural growth story for Indian IT sector remains intact, and TCS being the flagbearer would emerge stronger. Notwithstanding near-term volatility, we remain constructive on TCS for long term and maintain Buy on TCS with an unchanged PT of Rs. 3,650. We advise investors to adopt a staggered approach to invest from long term perspective.

TCS reported revenue growth of 2.2% q-o-q and 13.5% y-o-y in CC terms ahead of our and street expectations of 1.5% q-o-q CC growth in a seasonally weak quarter, driven by cloud services, market share gains through vendor consolidation, and continued momentum in North America and U.K. In USD terms, revenues were up by 2.9% q-o-q aided by currency tailwind of 70 bps. EBIT margin at 24.5%, improvement of 50 bps q-o-q, was broadly in-line with street estimates led by currency benefits and better execution but offset by third party costs and return to normalcy costs. As supply-side pressures wane and utilization improves, the management has expressed optimism on EBIT margin front and has guided for 25% exit margin for FY23. All industries saw broad-based growth in the quarter with retail vertical leading the charge with 18.7% growth year-on-year. The company reported a headcount reduction of 2,197 employees, a decline for the first time in 10 quarters. Attrition rate (on an LTM basis) was high at 21.3% but decreased by 20 bps q-o-q which indicates the improved productivity built over previous quarters and investments in organic talent development. Deal TCV wins moderated further sequentially but were steady at $7.8 billion vs $8.1 billion in Q2FY23, in-line with long term average while the book-to-bill ratio stood at 1x. The company announced Interim Dividend of Rs 8/Share and a Special Dividend of Rs 67/ Share. For the immediate near-term management commentary on geographies indicated varying levels of uncertainty due to the persisting macro-overhang. However, they have indicated greater confidence with respect to US and even UK while in case of Europe they are indicating caution for medium term. Owing to multiple global headwinds outlook for FY24E looks uncertain and recovery can be gradual but we believe the structural growth story for Indian IT sector remains intact, and TCS being the flagbearer would emerge stronger. Notwithstanding near-term volatility we remain constructive on TCS for long term and maintain Buy on TCS with an unchanged PT of Rs. 3,650. We advise investors to adopt a staggered approach to invest into the stock from long term perspective.

Key positives

- EBIT margin improved by 50 bps to 24.5%. The management have guided for 25% exit margin for FY23 implying further 50bps improvement in Q4FY23.
- LTM attrition in IT Services trended down at 21.3%, improving by 20 bps.
- Client $50M+ up by 12 on y-o-y and by 6 on q-o-q

Key negatives

- TCS shed 2197 employees, reflecting first headcount reduction in 10 quarters
- Order book at $7.8 billion in Q3FY23 Vs S8.1 billion in Q2FY23, with a book to bill ratio of 1x

Management Commentary

- The management stated that the demand environment has not changed significantly despite the macro situation for FY23. However, while uncertainty prevails in the near term, they have indicated greater confidence with demand situation in US and UK but have expressed caution for Europe.
- Management indicated optimism on achieving 25% exit EBIT margin by Q4FY23

Revision in estimates – We have fine-tuned our estimates for FY23/24/25 owing to macro-overhang and INR-USD reset.

Our Call

Valuation – Maintain Buy with an unchanged PT of Rs. 3,650: At the current juncture, owing to multiple global headwinds outlook for FY24E looks uncertain, and recovery could be gradual in the coming quarters. However, we believe the structural growth story for Indian IT sector remains intact, and TCS being the flagbearer would emerge stronger. Notwithstanding near-term volatility, we remain constructive on TCS for long term and maintain Buy on TCS with an unchanged PT of Rs. 3,650. We advise investors to adopt a staggered approach to invest from long term perspective.

Key Risks

Rupee appreciation and/or adverse cross-currency movements and/or constraint in local talent supply in the US would affect earnings. Further, macro headwinds and a possible recession in the US are likely to moderate the pace of technology spending.

Valuation Rs cr

Particulars	FY2022	FY2023E	FY2024E	FY2025E
Revenue	1,91,754.0	2,25,023.3	2,37,204.6	2,54,980.3
OPM (%)	27.7	26.3	26.8	27.0
Adjusted PAT	38,327.0	42,035.6	45,817.8	49,893.7
% y-o-y growth	*14.8*	*9.7*	*9.0*	*8.9*
Adjusted EPS (Rs)	103.6	114.9	125.2	136.3
P/E (x)	32.0	28.9	26.5	24.3
P/B (x)	13.7	12.4	10.8	10.6
EV/EBITDA	22.1	19.8	18.2	16.9
ROE %	43.3	44.7	43.6	44.1
ROCE %	49.6	51.1	48.9	51.8

Source: Company; Sharekhan estimates

Stock Update

Result Update

Key highlights of Management Commentary

- **Commentary on verticals:** Regional Markets, Life science & healthcare and Manufacturing posted strong sequential growth rates of 7.3%, 3.9% and 2.9% respectively. Technology services grew at 1.7% q-o-q, BFSI and Retail & CPG grew at 1.6% q-o-q each and Communication & Media grew at 1.3% q-o-q, which was below the overall company growth rate of 2.9% q-o-q. The company said it is difficult to say whether the strong sequential growth in regional markets is sustainable though India has done well. The management is cautious over the manufacturing segment due to global supply chain disruptions. TCS is confident over growth in the Travel, Retail and CPG vertical. BFSI is doing well but with some weakness in the insurance sector.
- **Broad-based growth across verticals:** Barring the 2.5% q-o-q sequential decline in in MEA, North America, Latin America, UK, Continental Europe, India and APAC grew sequentially by 1.7%, 8.9%, 5.7%, 5% and 2.9% respectively. The overall demand scenario has not change considerably. UK decision making is fast but will need to wait and watch for the US. Decision making process has slowed down in Europe.
- **Margin performance and guidance:** EBIT margins of 24.5% was in-line with our expectations led by 70 bps benefit from a depreciation of the Indian Rupee and a 30-bps improvement from better operational efficiency which was partially offset by third party costs and costs related to return to normalcy. TCS gave an EBIT guidance of 25% by Q4FY23.
- **Decline in headcount and attrition rate:** The company's headcount stood at 6,13,974, a net decrease of 2,197 employees q-o-q. High hiring in the past affected productivity levels so decline in headcount does not indicate sluggish demand. Attrition rate (on an LTM basis) was high at 21.3% but decreased by 20 bps q-o-q. The management will continue to focus on lowering attrition rate going forward.
- **Client metrics:** The number of '$100-million' clients remained flat q-o-q at 59 clients. The number of clients under the 50/20/10/5 increased by 6, 7, 1 & 8 q-o-q taking the count of such clients to 130, 290, 456 and 658.
- **Decline in deal TCV, but in line with long-term average:** TCV at $7.8 billion declined by 3.7% q-o-q but is in-line with TCS' long-term average deal value of $7-9 billion per quarter. TCV declined despite vendor consolidation due to delay in decision making. The company signed deals worth $4.2 billion in North America, $2.5 billion in the BFSI vertical and $2.1 billion in the retail vertical.
- **Commentary on pricing:** There is advantage of pricing on transformation deals whereas the cost optimization deals will be competitively built in.
- **Cash generation remained strong:** Cash & cash equivalents stood at INR 669 Billion. Cash flow from operations was strong at 102.8% of net profit.

Results Rs cr

Particulars	Q3FY23	Q3FY22	Q2FY23	Y-o-Y %	Q-o-Q %
Revenues In USD (mn)	**7,075.0**	**6,524.0**	**6,877.0**	**8.4**	**2.9**
Revenues In INR	**58,229.0**	**48,885.0**	**55,309.0**	**19.1**	**5.3**
Direct Costs	33,942.0	28,401.0	32,526.0	19.5	4.4
Gross Profit	**24,287.0**	**20,484.0**	**22,783.0**	**18.6**	**6.6**
SG&A	8,733.0	7,051.0	8,267.0	23.9	5.6
EBITDA	**15,554.0**	**13,433.0**	**14,516.0**	**15.8**	**7.2**
Depr & amort.	1,270.0	1,196.0	1,237.0	6.2	2.7
EBIT	**14,284.0**	**12,237.0**	**13,279.0**	**16.7**	**7.6**
Other Income	360.0	954.0	817.0	-62.3	-55.9
PBT	**14,644.0**	**13,191.0**	**14,096.0**	**11.0**	**3.9**
Tax Provision	3,761.0	3,385.0	3,631.0	11.1	3.6
PAT	**10,883.0**	**9,806.0**	**10,465.0**	**11.0**	**4.0**
Minority interest/Share of associates	37.0	37.0	34.0	0.0	8.8
Adj. Net Profit	**10,846.0**	**9,769.0**	**10,431.0**	**11.0**	**4.0**
EPS (Rs)	**29.6**	**26.4**	**28.5**	**12.2**	**4.0**
Margin (%)					
GPM	41.7	41.9	41.2	-19.3	51.7
EBITDA	26.7	27.5	26.2	-77	47
EBIT	24.5	25.0	24.0	-50	52
NPM	18.6	20.0	18.9	-136	-23
Tax rate	25.7	25.7	25.8	2	-8

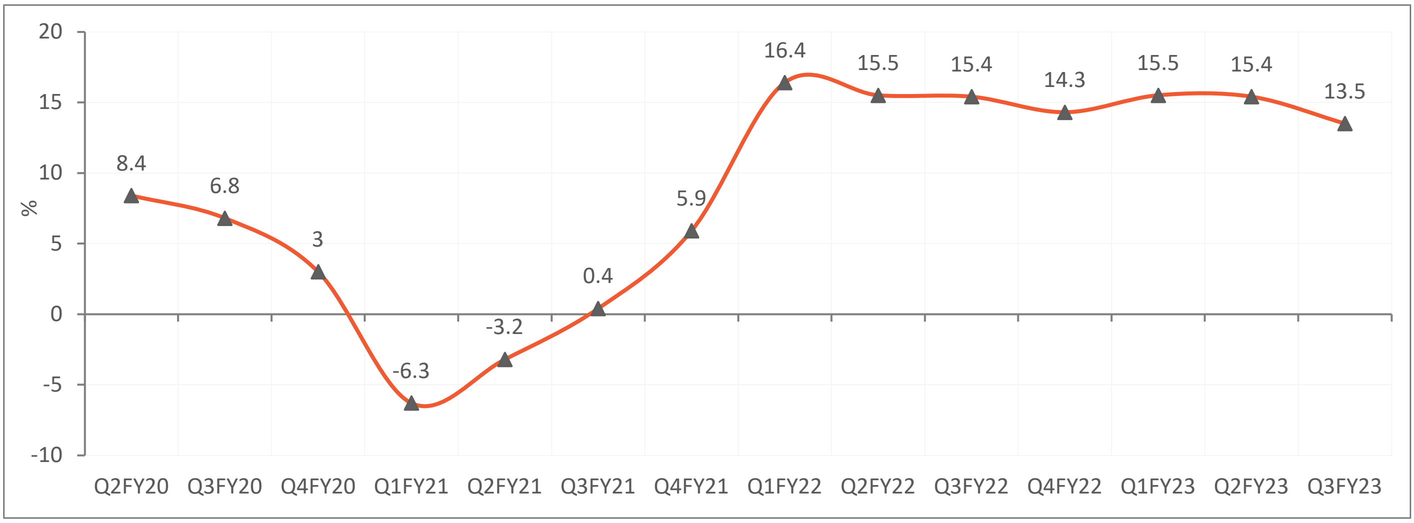
Source: Company; Sharekhan Research

Operating metrics

Particulars	Revenues	Contribution	$ Growth (%)		CC growth (%)
	($ mn)	(%)	Q-o-Q %	Y-o-Y %	Y-o-Y %
Revenues ($ mn)	7,075	100	2.9	8.4	13.5
Geographic mix					
North America	3,799	53.7	1.7	14.9	15.4
Latin America	127	1.8	8.9	14.8	14.6
UK	1,054	14.9	5.7	3.6	15.4
Continental Europe	1,047	14.8	5.0	0.3	9.7
India	361	5.1	2.9	0.6	9.1
APAC	559	7.9	1.6	-0.4	9.5
MEA	127	1.8	-2.5	2.7	8.6
Industry verticals					
BFSI	2,229	31.5	1.6	6.4	11.1
Retail & CPG	1,111	15.7	1.6	12.8	18.7
Communication & media	467	6.6	1.3	10.1	13.5
Manufacturing	700	9.9	2.9	8.4	12.5
Life Science and healthcare	729	10.3	3.9	12.8	14.4
Technology & services	630	8.9	1.7	10.9	13.6
Regional markets and others	1,210	17.1	7.3	4.2	13.3

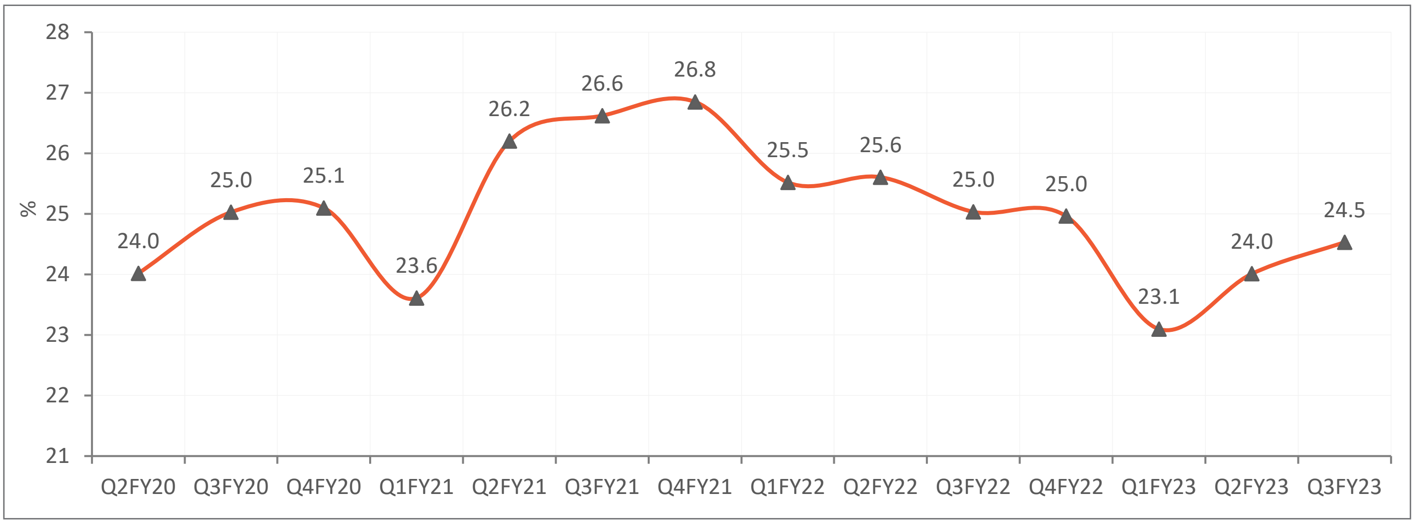
Source: Company; Sharekhan Research

TCS' constant-currency revenue growth (y-o-y) trend



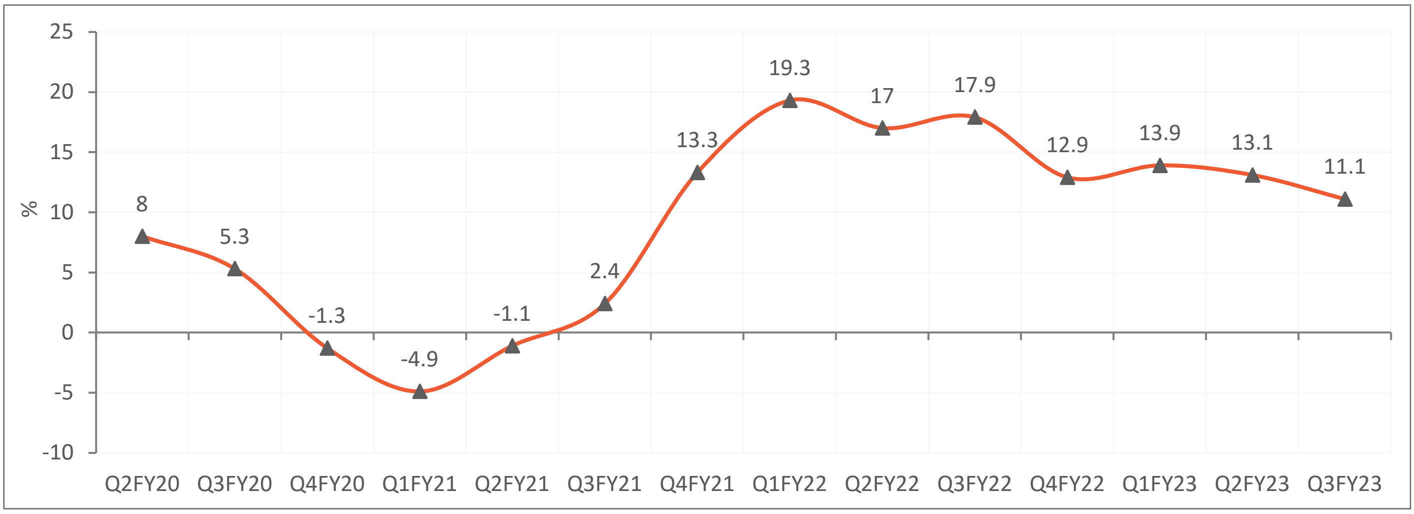
Source: Company, Sharekhan Research

EBIT margin trend



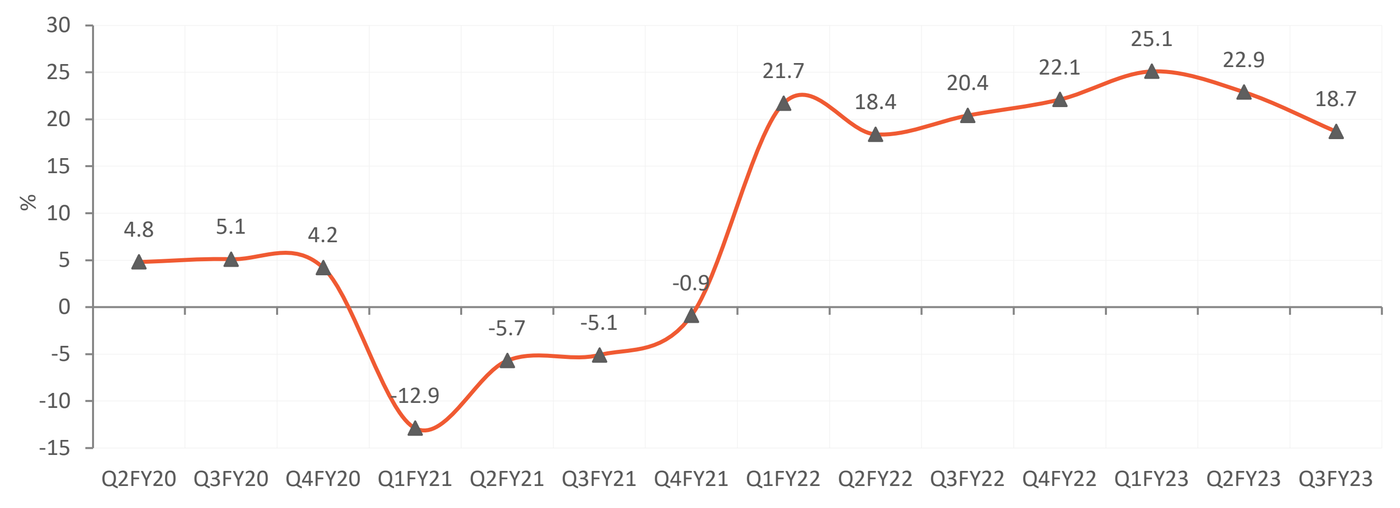
Source: Company, Sharekhan Research

BFSI revenue growth trend



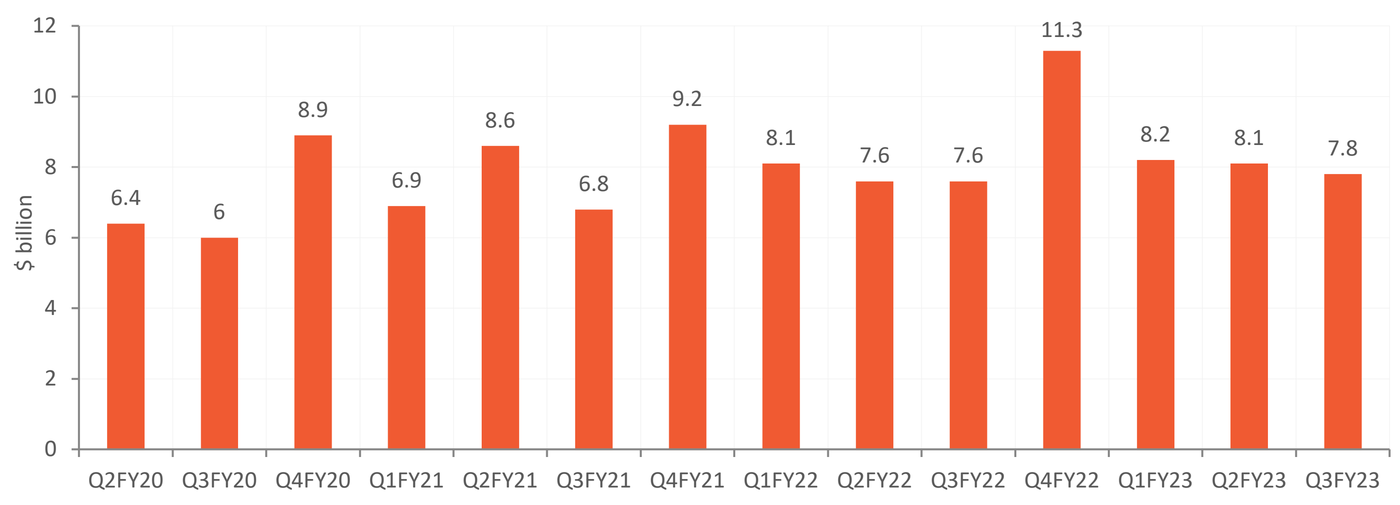
Source: Company, Sharekhan Research

Retail vertical trend



Source: Company, Sharekhan Research

TCVs largely stabel and in-line with long term average



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector View – Persisting multiple global headwinds turning outlook for FY24E uncertain

Owing to multiple global headwinds the outlook for FY24E looks uncertain, and the recovery could be gradual in the coming quarters. Hence concerns relating to macro headwinds are unlikely to abate anytime soon thus restricting any material outperformance for Indian IT companies.

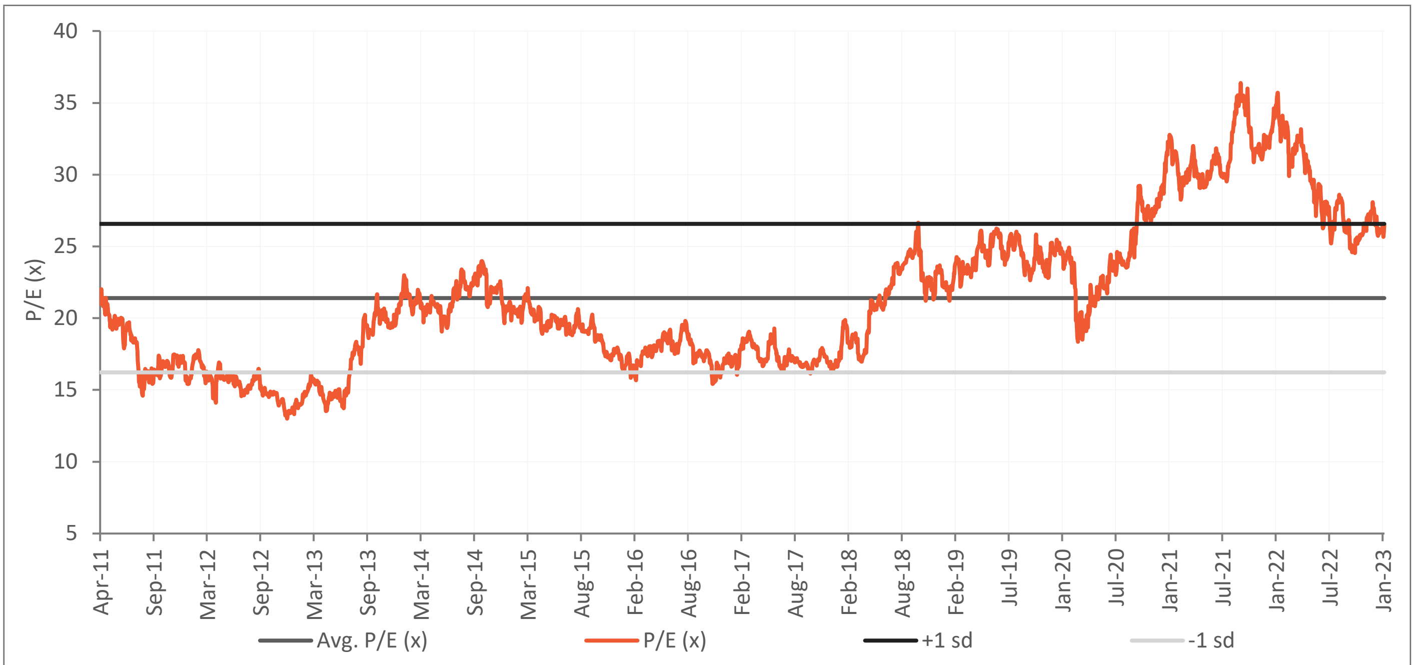
■ Company Outlook – Staying ahead of the race

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 an unchanged PT of Rs. 3,650

At the current juncture, owing to multiple global headwinds outlook for FY24E looks uncertain, and recovery could be gradual in the coming quarters. However, we believe the structural growth story for Indian IT sector remains intact, and TCS being the flagbearer would emerge stronger. Notwithstanding near-term volatility, we remain constructive on TCS for long term and maintain Buy on TCS with an unchanged PT of Rs. 3,650. We advise investors to adopt a staggered approach to invest from long term perspective.

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/EBITDA (x)		P/BV (x)		RoE (%)	
				FY23E	FY24E	FY23E	FY24E	FY23E	FY24E	FY23E	FY24E
HCL Tech	1,068	271	2,89,711	17.7	15.4	11.4	10.0	3.9	3.7	22.0	23.7
Infosys	1,485	421	6,24,690	24.9	24.0	16.4	15.6	4.2	3.9	30.9	29.8
TCS	3,320	366	12,14,805	28.9	26.5	19.8	18.2	12.4	10.8	44.7	43.6

Source: Company, Sharekhan estimates

About company

TCS is among the pioneers of IT services outsourcing business in India and is the largest ($25,707 million revenue in FY2022) 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

Rupee appreciation and/or adverse cross-currency movements, 2) constraint in local talent supply in the US would have an adverse impact on its earnings and 3) macro headwinds and possible recession in the US are likely to moderate the pace of technology spending.

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	3.65
2	Vanguard Group Inc.	0.94
3	BlackRock Inc.	0.88
4	Invesco Ltd.	0.86
5	SBI Funds Management Pvt. Ltd.	0.85
6	JPMorgan Chase & Co.	0.72
7	Axis Asset Management Co. Ltd.	0.63
8	First State Investments ICVC	0.41
9	FMR LLC	0.32
10	UTI Asset Management	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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Compliance Officer: Ms. Binkle Oza; Tel: 022-61150000; email id: complianceofficer@sharekhan.com;

For any queries or grievances kindly email igc@sharekhan.com or contact: myaccount@sharekhan.com.

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