

ADD

TP: Rs 2,230 | ▲ 11%

**TATA CONSULTANCY
SERVICES**

| IT Services

| 11 October 2019

Disappoints for second consecutive quarter

TCS reported a dull Q2FY20 operating performance with both revenues (+1.6% QoQ CC) and EBIT margins (flat at 24%) disappointing for the second straight quarter. This virtually rules out the possibility of double-digit growth for FY20 and marks a deepening revenue slowdown. We trim FY21/ FY22 EPS by 5%/6%, lower our target P/E to 22.5x (vs. 23x) and roll over to a new Sep'20 TP of Rs 2,230 (from Rs 2,360). We like the company's strong structural backbone but expect near-term stock weakness on growth concerns.

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Operating performance misses the mark for second straight quarter: TCS reported a soft Q2FY19 with 1.6% QoQ CC revenue growth and largely flat EBIT margins vs. our/consensus estimates of 2.6% QoQ CC growth and ~120bps QoQ margin improvement. The revenue miss stemmed from continued weakness in the BFSI and retail verticals, while a double whammy from cost-revenue mismatch and the absence of currency tailwinds cramped margins.

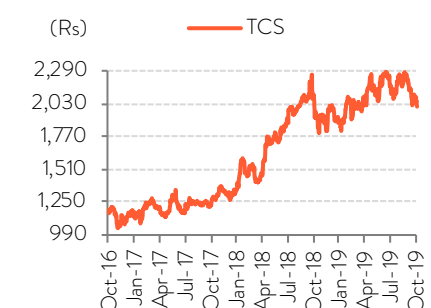
Soft showing in BFSI and retail yet again: TCS posted just 1.2% QoQ growth in BFSI and a 0.8% decline in retail (in US\$ terms). Management highlighted increasing stress in North American capital markets and at European banks that hurt BFSI performance, while broad-based weakness and delayed deal closures hurt retail performance.

Healthy deal wins and industry-low attrition were the bright spots: Deal wins at US\$ 6.4bn were the highest for the company in the last six quarters. Similarly, BFSI engagements at US\$ 2.2bn also marked a six-quarter high. LTM attrition at 11.6%, up 10bps QoQ, was stable and one of the lowest in the industry.

Ticker/Price	TCS IN/Rs 2,004
Market cap	US\$ 105.9bn
Shares o/s	3,753mn
3M ADV	US\$ 76.4mn
52wk high/low	Rs 2,296/Rs 1,784
Promoter/FPI/DII	72%/17%/11%

Source: NSE

STOCK PERFORMANCE



Source: NSE

KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
Total revenue (Rs mn)	12,31,040	14,64,630	15,62,041	16,87,009	18,56,580
EBITDA (Rs mn)	3,25,160	3,95,050	4,14,138	4,56,047	5,01,944
Adj. net profit (Rs mn)	2,58,260	3,15,240	3,21,615	3,53,699	3,93,304
Adj. EPS (Rs)	67.1	84.0	85.7	94.3	104.8
Adj. EPS growth (%)	0.6	25.3	2.0	10.0	11.2
Adj. ROAE (%)	29.3	35.5	32.7	30.5	29.1
Adj. P/E (x)	29.9	23.9	23.4	21.3	19.1
EV/EBITDA (x)	23.0	18.9	18.0	16.0	14.2

Source: Company, BOBCAPS Research

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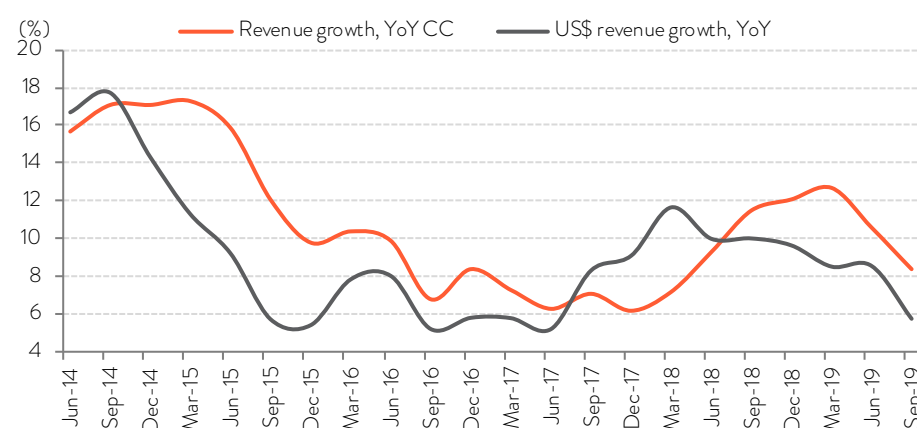
Important disclosures, including any required research certifications, are provided at the end of this report.



Earnings call highlights

- **BFSI:** Insurance, regional and small banks continue to grow. But weakness accelerated in US capital markets and large European banks.
- **Retail:** Delays in deal signing coupled with a broad-based slowdown in European and US retail muted growth in this vertical. Recovery in retail is contingent on closure of delayed deals.
- **Regional markets:** Management indicated that the company's product portfolio and platform performance remain strong, but synchronised weakness is visible in emerging markets such as India and Japan.
- **Outlook:** H2FY20 visibility looks cloudy. Management expects the usual seasonal weakness of the December quarter to play out. Though structural demand drivers are intact, the company indicated that a cautious client approach led by global macro concerns is slowing decision-making. TCS reiterated its continued strength in competitiveness and high deal participation.
- **Deal wins:** Deal wins at US\$ 6.4bn were the highest for the company in the last six quarters. Similarly, BFSI engagements at US\$ 2.2bn also marked a six-quarter high. Retail and North America wins stood at US\$ 830mn and US\$ 6.2bn respectively. Management pointed to a trend of increasing deal sizes and tenors.
- **Operating margins:** A cost-revenue mismatch coupled with the absence of currency-led tailwinds led to the operating margin miss in Q2. Near-term hiring moderation (to optimise utilisation) and employee pyramid correction are the tactical (or near-term) and structural (long-term) margin levers.

FIG 1 – REVENUES MISSED ESTIMATES ON CONTINUED WEAKNESS IN BFSI AND RETAIL VERTICALS

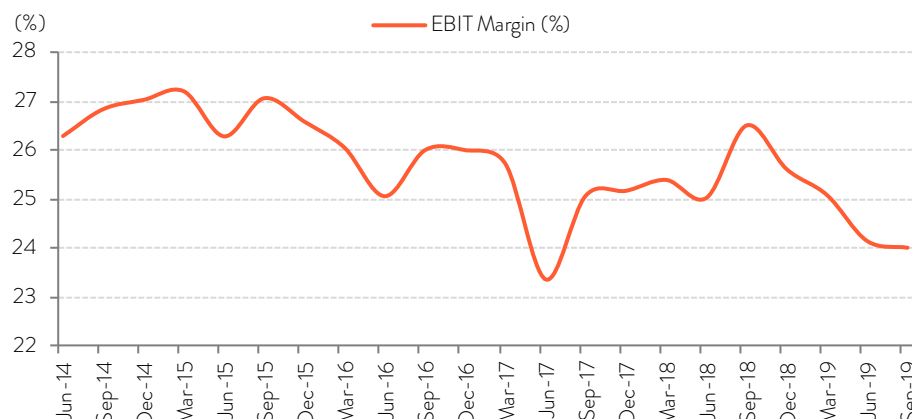


Source: Company, BOBCAPS Research

Disappointing show for second quarter in a row rules out double-digit growth for FY20 as trend of revenue growth moderation deepens

FIG 2 – OPERATING MARGINS BUCK THE TREND OF SEASONAL STRENGTH IN Q2FY20

Double whammy of cost-revenue mismatch and lack of currency-led tailwinds led to operating margin miss



Source: Company, BOBCAPS Research

FIG 3 – SEP'19 QUARTER PERFORMANCE

(Rs mn)	Q1FY19	Q2FY19	Q3FY19	Q4FY19	Q1FY20	Q2FY20	YoY (%)	QoQ (%)	H1FY19	H2FY20	YoY (%)
Revenues (US\$ mn)	5,051	5,215	5,250	5,397	5,485	5,517	5.8	0.6	10,266	11,002	7.2
Revenue (Rs mn)	3,42,610	3,68,540	3,73,380	3,80,100	3,81,720	3,89,770	5.8	2.1	7,11,150	7,71,490	8.5
Operating Expenditure	2,51,900	2,65,760	2,72,550	2,79,370	2,81,350	2,87,510	8.2	2.2	5,17,660	5,68,860	9.9
Cost of revenues	1,96,850	2,07,950	2,13,200	2,17,090	2,21,020	2,24,100	7.8	1.4	4,04,800	4,45,120	10.0
as % of sales	57.5	56.4	57.1	57.1	57.9	57.5	-	-	56.9	57.7	-
SG&A expenses	55,050	57,810	59,350	62,280	60,330	63,410	9.7	5.1	1,12,860	1,23,740	9.6
as % of sales	16.1	15.7	15.9	16.4	15.8	16.3	-	-	15.9	16.0	-
EBITDA	90,710	1,02,780	1,00,830	1,00,730	1,00,370	1,02,260	(0.5)	1.9	1,93,490	2,02,630	4.7
Depreciation	4,930	5,070	5,190	5,360	8,170	8,650	70.6	5.9	10,000	16,820	68.2
EBIT	85,780	97,710	95,640	95,370	92,200	93,610	(4.2)	1.5	1,83,490	1,85,810	1.3
Other Income	12,080	5,930	11,470	11,650	14,180	11,680	97.0	(17.6)	18,010	25,860	43.6
PBT	97,860	1,03,640	1,07,110	1,07,020	1,06,380	1,05,290	1.6	(1.0)	2,01,500	2,11,670	5.0
Total Tax	24,240	24,370	25,900	25,500	24,850	24,710	1.4	(0.6)	48,610	49,560	2.0
Adjusted PAT	73,620	79,270	81,210	81,520	81,530	80,580	1.7	(1.2)	1,52,890	1,62,110	6.0
(Profit)/loss from JV's/Ass/MI	(220)	260	(160)	(260)	(220)	(160)	-	-	40	(380)	-
APAT after MI	73,400	79,530	81,050	81,260	81,310	80,420	1.1	(1.1)	1,52,930	1,61,730	5.8
Extraordinary items	-	-	-	-	-	-	-	-	0	-	-
Reported PAT	73,400	79,530	81,050	81,260	81,310	80,420	1.1	(1.1)	1,52,930	1,61,730	5.8
Reported EPS	19.2	20.7	21.6	21.7	21.7	21.4	3.7	(1.1)	40	43	8.2
Margins (%)							(bps)	(bps)			(bps)
EBIDTA	26.5	27.9	27.0	26.5	26.3	26.2	(170)	(10)	27.2	26.3	(90)
EBIT	25.0	26.5	25.6	25.1	24.2	24.0	(250)	(10)	25.8	24.1	(170)
EBT	28.6	28.1	28.7	28.2	27.9	27.0	(110)	(90)	28.3	27.4	(90)
PAT	21.4	21.6	21.7	21.4	21.3	20.6	(90)	(70)	21.5	21.0	(50)
Effective Tax rate	24.8	23.5	24.2	23.8	23.4	23.5	-	10	24.1	23.4	(70)

Source: Company, BOBCAPS Research

FIG 4 – SEP'19 QUARTER OPERATING METRICS

	Q2FY20 (% Contr. to Revenue)	QoQ (%)	YoY (%)
Deal win TCV (in US\$ mn)	6,400	12.3	30.6
Digital revenues	33.2	3.7	25.0
Revenue by Geography			
Americas	50.6	0.6	4.8
UK	15.6	(0.7)	5.8
Europe	14.6	2.7	10.3
India	5.7	(4.4)	7.7
Asia Pac	9.4	0.6	3.6
Ibero America	1.9	(9.0)	2.2
MEA	2.2	22.9	10.8
Revenue by Vertical			
BFSI	31.0	1.2	5.1
Manufacturing	9.8	0.6	5.8
Telecom	7.0	3.5	8.9
Life Sciences & Healthcare	8.1	3.1	14.3
Retail & Distribution	14.8	(0.8)	1.7
Technology & Services	8.7	(0.6)	3.4
Regional Markets & Others	20.6	(0.4)	6.8
	Q2FY20	Q1FY20	Q2FY19
Attrition (LTM) (%)	11.6	11.5	10.9

Source: Company, BOBCAPS Research

Valuation methodology

We trim our FY21/FY22 EPS estimates by ~5%/6% following a downward reset of revenue growth assumptions. For FY20, we now build in 8.6% YoY CC or 6.6% YoY dollar revenue growth with 24.3% EBIT margins.

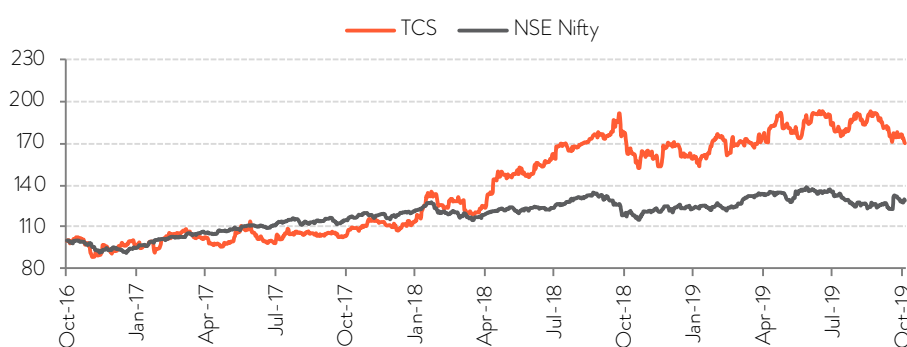
We value TCS at a P/E multiple of 22.5x vs. 23x earlier to factor in growth concerns considering that Q2FY20 marks the second consecutive quarter of revenue and margin weakness. On rolling valuations forward, we arrive at a revised Sep'20 target price of Rs 2,230 (vs. Rs 2,360). We like the company's strong structural backbone but expect near-term stock weakness on growth concerns. Maintain ADD.

FIG 5 – REVISED ESTIMATES

(Rs mn)	FY20E			FY21E			FY22E		
	Old	New	Chg (%)	Old	New	Chg (%)	Old	New	Chg (%)
Revenues (US\$ mn)	22,673	22,296	(1.7)	25,336	24,100	(4.9)	28,254	26,523	(6.1)
YoY growth (%)	8.4	6.6	-	11.7	8.1	-	11.5	10.1	-
Revenues	15,67,671	15,62,041	(0.4)	17,73,499	16,87,009	(4.9)	19,77,805	18,56,580	(6.1)
EBITDA	4,22,188	4,14,138	(1.9)	4,79,495	4,56,047	(4.9)	5,34,726	5,01,944	(6.1)
EBITDA margin (%)	26.9	26.5	-	27.0	27.0	-	27.0	27.0	-
Net profits	3,28,084	3,21,615	(2.0)	3,73,039	3,53,699	(5.2)	4,20,287	3,93,304	(6.4)
EPS (Rs)	87.4	85.7	(2.0)	99.4	94.3	(5.2)	112.0	104.8	(6.4)

Source: BOBCAPS Research

FIG 6 – RELATIVE STOCK PERFORMANCE



Source: NSE

Key risks

Downside risks to our estimates include:

- a sharp decline in IT spending,
- adverse currency movements,
- an inability to refresh service offerings amid rapidly changing technologies,
- execution risk in bundled deals.

FINANCIALS

Income Statement

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Total revenue	12,31,040	14,64,630	15,62,041	16,87,009	18,56,580
EBITDA	3,25,160	3,95,050	4,14,138	4,56,047	5,01,944
Depreciation	20,140	20,550	34,067	37,356	42,373
EBIT	3,05,020	3,74,500	3,80,071	4,18,691	4,59,571
Net interest income/(expenses)	0	0	0	0	0
Other income/(expenses)	35,900	41,130	42,500	47,755	58,987
Exceptional items	0	0	0	0	0
EBT	3,40,920	4,15,630	4,22,572	4,66,446	5,18,558
Income taxes	82,120	1,00,010	1,00,176	1,11,947	1,24,454
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	(540)	(380)	(780)	(800)	(800)
Reported net profit	2,58,260	3,15,240	3,21,615	3,53,699	3,93,304
Adjustments	0	0	0	0	0
Adjusted net profit	2,58,260	3,15,240	3,21,615	3,53,699	3,93,304

Balance Sheet

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Accounts payables	0	0	0	0	0
Other current liabilities	2,05,190	2,50,000	2,69,613	2,91,182	3,20,451
Provisions	0	0	0	0	0
Debt funds	2,470	440	440	440	440
Other liabilities	0	0	0	0	0
Equity capital	1,910	3,750	3,750	3,750	3,750
Reserves & surplus	0	0	0	0	0
Shareholders' fund	8,76,430	8,98,990	10,66,560	12,50,788	14,55,555
Total liabilities and equities	10,84,090	11,49,430	13,36,612	15,42,410	17,76,446
Cash and cash eq.	48,830	72,240	2,18,830	3,79,284	5,52,126
Accounts receivables	2,49,430	2,73,460	2,99,569	3,23,536	3,56,056
Inventories	0	0	0	0	0
Other current assets	1,22,470	2,43,530	2,56,774	2,77,317	3,05,191
Investments	4,07,310	3,49,540	3,49,540	3,49,540	3,49,540
Net fixed assets	1,16,000	1,13,740	1,10,914	1,07,299	1,02,058
CWIP	0	0	0	0	0
Intangible assets	38,960	18,790	18,790	18,790	18,790
Deferred tax assets, net	34,230	26,560	26,560	26,560	26,560
Other assets	66,860	51,570	55,634	60,085	66,125
Total assets	10,84,090	11,49,430	13,36,612	15,42,410	17,76,446

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Net income + Depreciation	2,02,850	2,36,600	3,56,462	3,91,855	4,36,477
Interest expenses	(23,930)	(25,640)	(42,500)	(47,755)	(58,987)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(2,090)	(21,690)	(23,805)	(27,390)	(37,166)
Other operating cash flows	73,840	96,660	0	0	0
Cash flow from operations	2,50,670	2,85,930	2,90,156	3,16,710	3,40,323
Capital expenditures	(18,040)	(21,320)	(31,241)	(33,740)	(37,132)
Change in investments	60,090	73,820	0	0	0
Other investing cash flows	(11,010)	(36,050)	42,500	47,755	58,987
Cash flow from investing	31,040	16,450	11,259	14,015	21,855
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	(430)	(1,940)	0	0	0
Interest expenses	(1,60,820)	(1,62,310)	0	0	0
Dividends paid	(1,07,600)	(1,14,720)	(1,54,826)	(1,70,271)	(1,89,337)
Other financing cash flows	0	0	0	0	0
Cash flow from financing	(2,68,850)	(2,78,970)	(1,54,826)	(1,70,271)	(1,89,337)
Changes in cash and cash eq.	12,860	23,410	1,46,590	1,60,454	1,72,842
Closing cash and cash eq.	48,830	72,240	2,18,830	3,79,284	5,52,126

Per Share

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20E	FY21E	FY22E
Reported EPS	67.1	84.0	85.7	94.3	104.8
Adjusted EPS	67.1	84.0	85.7	94.3	104.8
Dividend per share	24.1	30.0	34.3	37.7	41.9
Book value per share	227.6	239.5	284.2	333.3	387.9

Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19A	FY20E	FY21E	FY22E
EV/Sales	6.1	5.1	4.8	4.3	3.8
EV/EBITDA	23.0	18.9	18.0	16.0	14.2
Adjusted P/E	29.9	23.9	23.4	21.3	19.1
P/BV	8.8	8.4	7.1	6.0	5.2

DuPont Analysis

Y/E 31 Mar (%)	FY18A	FY19A	FY20E	FY21E	FY22E
Tax burden (Net profit/PBT)	75.8	75.8	76.1	75.8	75.8
Interest burden (PBT/EBIT)	111.8	111.0	111.2	111.4	112.8
EBIT margin (EBIT/Revenue)	24.8	25.6	24.3	24.8	24.8
Asset turnover (Revenue/Avg TA)	115.2	131.1	125.7	117.2	111.9
Leverage (Avg TA/Avg Equity)	1.2	1.3	1.3	1.2	1.2
Adjusted ROAE	29.3	35.5	32.7	30.5	29.1

Source: Company, BOBCAPS Research | Note: TA = Total Assets

Ratio Analysis

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
YoY growth (%)					
Revenue	4.4	19.0	6.7	8.0	10.1
EBITDA	0.6	21.5	4.8	10.1	10.1
Adjusted EPS	0.6	25.3	2.0	10.0	11.2
Profitability & Return ratios (%)					
EBITDA margin	26.4	27.0	26.5	27.0	27.0
EBIT margin	24.8	25.6	24.3	24.8	24.8
Adjusted profit margin	21.0	21.5	20.6	21.0	21.2
Adjusted ROAE	29.3	35.5	32.7	30.5	29.1
ROCE	27.5	34.3	34.6	37.0	39.3
Working capital days (days)					
Receivables	71	65	67	67	67
Inventory	0	0	0	0	0
Payables	74	78	83	83	82
Ratios (x)					
Gross asset turnover	10.5	12.8	13.9	15.5	17.7
Current ratio	2.4	2.6	3.1	3.6	4.0
Net interest coverage ratio	NA	NA	NA	NA	NA
Adjusted debt/equity	(0.1)	(0.1)	(0.2)	(0.3)	(0.4)

Source: Company, BOBCAPS Research

Disclaimer

Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

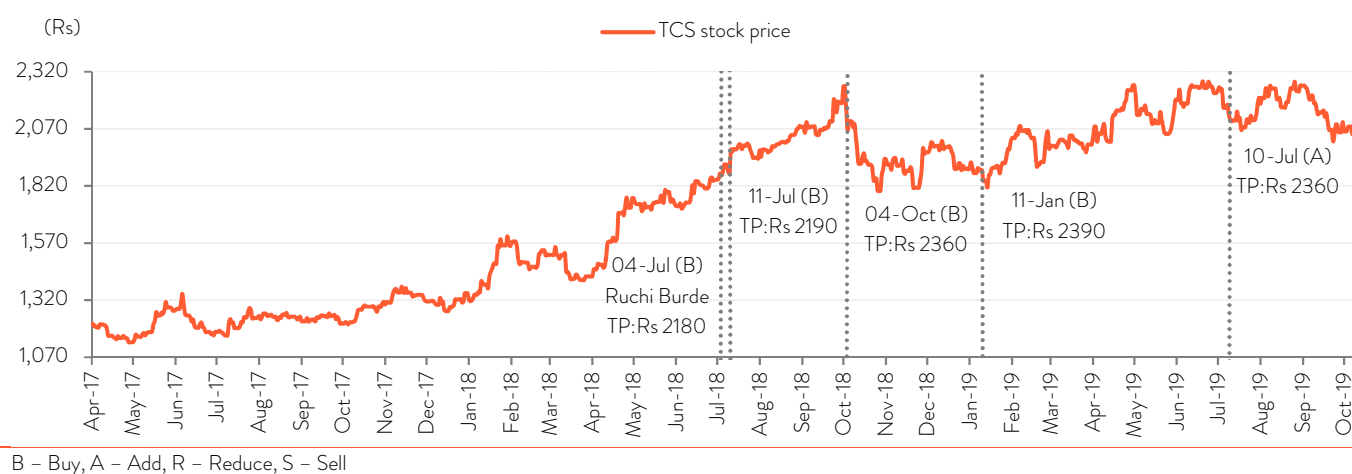
ADD – Expected return from >+5% to +15%

REDUCE – Expected return from -5% to +5%

SELL – Expected return <-5%

Note: Recommendation structure changed with effect from 1 January 2018 (Hold rating discontinued and replaced by Add / Reduce)

HISTORICAL RATINGS AND TARGET PRICE: TATA CONSULTANCY SERVICES (TCS IN)



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