Tata Consultancy Services

18 March 2019

Reuters: TCS.BO; Bloomberg: TCS IN

Management Meet Update

Hints At Momentum For Double-digit Growth In FY20, But BFSI Is Flatlining

We had a meeting with the management of Tata Consultancy Services (TCS) recently. We came away from the meeting a tad bit more positive on its FY20 revenue outlook. While it stated that the current momentum in most verticals would take TCS to double-digit growth in FY20, we still believe it may fall a tad shy off double digit. We understand that about 200bps-250bps of FY19 revenue growth came from major orders that it won in 2HFY18 –connected with its insurance platform. We have not seen announcement of similar kind of deals so far in 4QFY19. We therefore expect growth in FY20 to be a tad slower than in FY19. Some of the other key takeaways from the meeting include the following: (1) After a pick-up in growth from low single-digit level to high single-digit level on YoY basis over the past few quarters, the BFSI vertical is unlikely to witness a further pick-up in growth going into next year as there has been uneven spending by some of the larger customers in the banking space. This is in line with the commentary made by Cognizant in the past few quarters about selective growth witnessed in its large banking clients (Investor Day Update). TCS is of the view that this may be because of likely higher in-house spending (2) Continued weakness in the automobile and hi-tech customer segments - likely because of weakness across automobile industry globally and more so in China, slowdown in spending likely by semiconductor players because of their large exposure to China and also because of slower growth of telecom equipment vendors. Software ISV growth within the hi-tech space was indicated to be strong. After the meeting, we have revised upwards our revenue estimates for FY20/FY21, but would like to highlight the no-growth-year-for-industry-in-FY21 call. We retain our Sell rating on TCS with a March 2020 target price of Rs1,607 (at a target P/E of 16.5x March 2020E EPS, -1SD over the mean P/E multiple for the past five years). This target P/E multiple (highest in our coverage universe) is reflective of the strong position that TCS holds in the Indian IT service landscape by way of: (1) Its breadth in terms of service lines, geographies and verticals. (2) Ability to stitch together integrated offerings. (3) Significant lead in automation skills which will stand it in good stead in a likely slowdown that we are expecting in 2020. While it is an 'absolute' Sell, on a relative basis we prefer TCS (along with HCL Technologies and Infosys) within our coverage universe over the next 24 months as we believe it will be a beneficiary of vendor consolidation.

Negative margin surprise in 3QFY19 was driven by a spurt in activity in a seasonally weak quarter: TCS's investment in sub-contractors and increased hiring in 3QFY19 (see note Talent Hoarding Impacts Margins) stemmed from a faster-than-expected ramp-up by customers on their projects in a quarter which typically sees a seasonal slowdown. The call taken by the management was to not let go off any demand because of lack of internal resources. While it was not clear in our discussions, the sense we get is that the margin dip is unlikely to continue into 4QFY19. We understand that a part of the investment into higher-priced resources will be recouped with higher pricing on its services in subsequent quarters.

Spurt in 3QFY19 activity may be a sign of things to come: TCS did not specifically attribute the spurt in activity to any 'budget flush' where customers spend the amounts that they had set aside for the year. It is of the view that traditional seasonality may no longer be relevant as the execution of newer programs seem to beget fresh spending. This, according to TCS, is because of leaner and simplified applications and infrastructure of its customers removing traditional constraints that used to slow new initiatives.

Impact of recent macro deterioration: Except for the vertical segments stated above, there has not been any material change in the spending dynamics despite the recent news flow around macro deterioration. TCS indicated the continuing trend of repurposing spending as savings from making the legacy applications, infrastructure and processes leaner and more automated are being spent on new transformation programs which address the competitive position of the customer. TCS believes that being a player with end-to-end capabilities it is being viewed favourably by end-customers.

Investment in new age platforms likely: TCS in 3QFY19 indicated spending on industry-specific new age platforms along with customers. TCS stated that it continues to evaluate initiatives to make and/or buy some of these platforms across various verticals. Currently, we believe that TCS's platform strengths are largely in BFSI and retail verticals.

Gearing up for the 5G opportunity: As we had stated in our notes on Tech Mahindra, many of its peers are also investing to make a mark in the growth opportunity around 5G. TCS has done work with a Scandinavian communications service provider (CSP) in 5G. We understand this is on the enterprise side of the business and not on the network service side, although TCS has been investing in the latter part too.

TCS is of the view that H1-B visa-related changes have no impact on its business: While we have been highlighting labour-related problems that curtail demand fulfilment for a number of players in the industry (see our notes: Onsite Supply Bottleneck H1-B Related and Likely Change In H1-B Rules To Affect Execution & Costs) TCS was of the view that none of this has adversely impacted it and will unlikely to do so in future even if there are any change in policies. TCS stated there has been significant localisation and it is currently using only 1/10th the visas that it used to avail 10 years ago.

'Machine First' and 'Location Independent Agile' are two sides of the same coin: 'Machine First' is basically to use a higher level of automation in both the front-end as well as the back-end to reduce costs for the customer. The savings are used to drive 'Location Independent Agile'-based digital initiatives.

SELL

Sector: Information Technology

CMP: Rs2,040

Target price: Rs1,607

Downside: 21%

Girish Pai
Head of Research
girish.pai@nirmalbang.com
+91-22-6273 8017

Key Data

Current Shares O/S (mn)	3,752.4
Mkt Cap (Rsbn/US$bn)	7,654.7/110.7
52 Wk H / L (Rs)	2,276/1,391
Daily Vol. (3M NSE Avg.)	3,051,965

Price Performance (%)

	1 M	6 M	1 Yr
TCS	0.5	(1.2)	42.2
Nifty Index	6.6	(0.8)	10.3

Source: Bloomberg

Exhibit 1: Key financials

Y/E March (Rsbn)	FY17	FY18	FY19E	FY20E	FY21E
Revenue (Rsbn)	1,180	1,231	1,459	1,633	1,702
YoY Growth (%)	*8.6*	*4.4*	*18.5*	*11.9*	*4.3*
EBIT (Rsbn)	303	305	376	423	438
% of sales	*25.7*	*24.8*	*25.8*	*25.9*	*25.7*
PAT (Rsbn)	263	258	314	345	365
YoY Growth (%)	*8.6*	*(1.8)*	*21.6*	*9.9*	*5.9*
FDEPS (Rs)	66.7	67.0	82.9	92.0	97.4
RoE (%)	*32.4*	*29.3*	*36.2*	*36.0*	*31.5*
RoCE (%)	*33.7*	*30.7*	*37.2*	*37.9*	*33.1*
Pre Tax ROIC (%)	*60.8*	*57.3*	*61.7*	*61.5*	*61.1*
P/E (x)	30.6	30.4	24.6	22.2	20.9
P/BV (x)	8.8	8.9	9.1	7.4	6.2

Source: Company, Nirmal Bang Institutional Equities Research

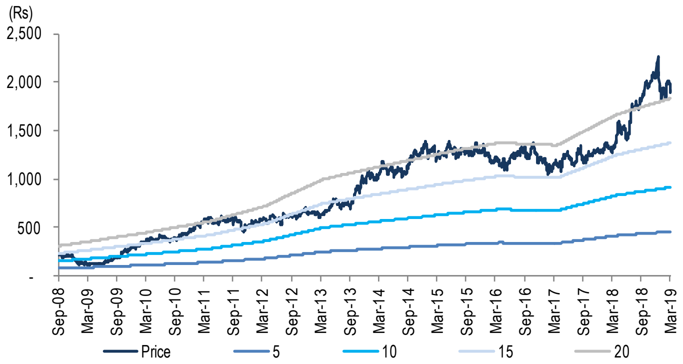
Exhibit 2: Change in our estimates

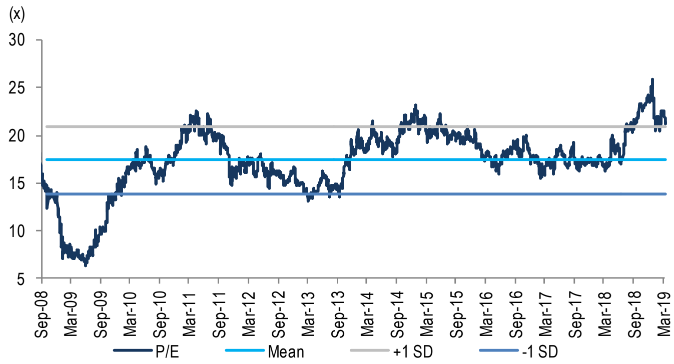
	New			Old			*Change (%)*		
	FY19E	FY20E	FY21E	FY19E	FY20E	FY21E	*FY19E*	*FY20E*	*FY21E*
INR/USD	70.0	72.0	74.5	70.0	72.0	74.5	-	-	-
USD Revenue (USD mn)	20,871	22,673	22,847	20,871	22,499	22,504	-	*0.8*	*1.5*
Revenue (Rsbn)	1,459	1,633	1,702	1,459	1,620	1,676	-	*0.8*	*1.5*
EBIT (Rsbn)	376	423	438	376	419	431	-	*0.8*	*1.6*
EBIT Margin (%)	*25.8*	*25.9*	*25.7*	*25.8*	*25.9*	*25.7*	-	*0.1*	*0.1*
PAT (Rsbn)	314	345	365	314	343	360	-	*0.8*	*1.4*
FDEPS (Rs)	82.9	92.0	97.4	82.9	91.3	96.0	-	*0.8*	*1.4*

Source: Company, Nirmal Bang Institutional Equities Research

View on Indian IT services sector: We downgraded the Indian IT sector (see our report: Street Is Not Factoring Even A Soft Landing; We Downgrade) on 27 December 2018 based on: (1) Consensus not factoring in significantly softer growth in FY21 as the best demand environment since 2008-09 is largely behind us with corporate capex in both the US and Europe likely to have peaked in 2018. (2) The US BFSI space could witness pressure on margins from a flattened/inverted yield curve and probably a more hostile regulatory environment through a split Congress in the US. (3) Pressure on cost structure because of tariffs levied on imports from China impacting US manufacturers. (4) Front-office capabilities in digital still elusive for Indian IT services players, leading to inability to tap into the marketing budgets of customers in a material way. The focus has been on the technology-intensive back-end of digital where we believe the field is relatively more crowded. (5) 'Automation at scale' in legacy services eating into growth coming in from new services. This is driven by explosive growth in both intelligent and robotic process automation software industry. (6) Factoring in lower Indian rupee or INR depreciation benefits than estimated earlier (Refer: Incorporating New INR Estimate). (7) Capital return to shareholders not being as potent a stock driver as it was earlier because the cash hoard is shrinking after two to three rounds of buyback over the past three years. (8) Talent pressure in the US in new age services because of a tighter H1-B visa regime. We were planning the downgrade a quarter or two down the road, but the global macro set-up has turned weaker far more quickly than we anticipated, hastening this move. While some of the 'relative' factors - investor positioning, valuation and earnings revision momentum - partly the reasons for turning 'tactically positive in March 2018 still exist, we believe they are unlikely to carry as much importance with investors as deteriorating fundamentals would over FY19-FY21. While many of our competitors are expecting a better FY20 versus FY19, we believe that is unlikely. We probably had the best macro environment that the industry has seen in the past 10 years in 2018 and incrementally we only see a deterioration which should crimp spending by customers. More importantly, we reiterate our no-industry-growth-in-FY21 call initiated in March 2018. We base this scenario on an explicit expectation of a soft landing in the US (0%-1.5% real GDP growth) in 2020. We believe consensus is expecting mid-high single-digit revenue growth in FY21 for the industry, implicitly assuming continued robust growth in the US (2%-2.5%). It is our belief that the street will converge with our no-growth expectation over time. Until the market prices in this scenario, we believe technical factors are not likely to hold the sector up. A hard landing (recession) - not our current base case - could lead to single-digit negative growth for the sector. Just as outperformance of the sector in 2018 was driven largely by P/E multiple expansion in the belief that growth is going to accelerate, we believe the downside in 2019 will be driven by P/E multiple deflation as investors begin to re-calibrate growth expectations lower over FY19-FY21. We prefer large-caps over mid-caps. The faster growth shown by select mid-caps is a case of 'rising tide lifting all boats', a smaller base and lower exposure to legacy services. But as digital demand shifts from the front to back, we believe that traditional large Indian companies will be in a better position to capture the market. We would advise investors to focus on sustainability and not overpay for a riskier business model - some companies have seen client concentration rising over the past two years.

Exhibit 3: P/E multiple charts





Source: Bloomberg, Nirmal Bang Institutional Equities Research

Source: Bloomberg, Nirmal Bang Institutional Equities Research

Financials

Exhibit 4: Income statement

Y/E March (Rsbn)	FY17	FY18	FY19E	FY20E	FY21E
Average INR/USD	**67.1**	**64.5**	**70.0**	**72.0**	**74.5**
Net Sales (USD mn)	**17,575**	**19,089**	**20,871**	**22,673**	**22,847**
-Growth (%)	***6.2***	***8.6***	***9.3***	***8.6***	***0.8***
Net Sales	1,180	1,231	1,459	1,633	1,702
-Growth (%)	*8.6*	*4.4*	*18.5*	*11.9*	*4.3*
Cost of Sales & Services	669	713	848	950	998
Gross Margin	511	518	612	682	704
% of sales	*43.3*	*42.1*	*41.9*	*41.8*	*41.3*
SG& A	208	213	236	260	265
% of sales	*17.6*	*17.3*	*16.1*	*15.9*	*15.6*
EBIT	303	305	376	423	438
EBIT Margin (%)	***25.7***	***24.8***	***25.8***	***25.9***	***25.7***
Other income (net)	42	36	39	35	47
PBT	345	341	416	458	485
-PBT margin (%)	29.3	27.7	28.5	28.1	28.5
Provision for tax	82	82	101	112	119
Effective tax rate (%)	23.6	24.1	24.2	24.5	24.5
Minority Interest	1	1	1	1	1
Net profit	**263**	**258**	**314**	**345**	**365**
-Growth (%)	*8.6*	*(1.8)*	*21.6*	*9.9*	*5.9*
-Net profit margin (%)	*22.3*	*21.0*	*21.5*	*21.1*	*21.5*
Average Shares outstanding-Basic	3,941	3,829	3,790	3,752	3,752

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 5: Cash flow

Y/E March (Rsbn)	FY17	FY18	FY19E	FY20E	FY21E
EBIT	**303**	**305**	**376**	**423**	**438**
(Inc.)/dec. in working capital	6	(20)	(77)	(36)	(10)
Cash flow from operations	**309**	**285**	**299**	**387**	**429**
Other income	42	36	39	35	
Depreciation & amortisation	20	20	25	20	20
Financial expenses	-	-	-	-	-
Tax paid	(82)	(82)	(101)	(112)	(119)
Dividends paid	(112)	(116)	(133)	(150)	(158)
Net cash from operations	**178**	**143**	**130**	**180**	**172**
Capital expenditure	(19)	(19)	(23)	(21)	(21)
Net cash after capex	159	124	107	160	151
Inc./(dec.) in debt	0	(0)	(2)	-	-
(Inc.)/dec. in investments	(192)	60	59	-	-
Equity issue/(Share Buyback)	-	(160)	(160)	-	-
Cash from financial activities	**(191)**	**(101)**	**(103)**	**-**	**-**
Others	5	5	(39)	(1)	46
Opening cash	67	40	69	35	194
Closing cash	40	69	35	194	391
Change in cash	(28)	29	(35)	159	197

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 6: Balance sheet

Y/E March (Rsbn)	FY17	FY18	FY19E	FY20E	FY21E
Equity capital	2.0	1.9	3.8	3.8	3.8
Reserves & surplus	885	875	857	1,052	1,260
Net worth	887	876	860	1,056	1,264
Minority Interest	-	-	-	-	-
Other liabilities	21	29	30	34	34
Total loans	3	2	1	1	1
Total liabilities	**911**	**908**	**891**	**1,090**	**1,299**
Goodwill	38	39	40	40	40
Net block (incl. CWIP)	117	116	114	115	116
Investments	3	3	6	6	6
Deferred tax asset - net	28	34	30	34	34
Other non-current assets	62	76	65	70	71
Other current assets	485	427	465	472	474
Debtors	280	320	349	390	401
Cash & bank balance	36	49	52	52	52
Bank deposits	4	21	(18)	141	339
Total current assets	805	815	849	1,056	1,266
Total current liabilities	143	176	212	229	234
Net current assets	662	639	637	827	1,033
Total assets	**911**	**908**	**891**	**1,090**	**1,299**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 7: Key ratios

Y/E March	FY17	FY18	FY19E	FY20E	FY21E
Per Share (Rs)					
EPS	66.7	67.0	82.9	92.0	97.4
FDEPS	66.7	67.0	82.9	92.0	97.4
Dividend Per Share	23.5	25.1	29.1	33.1	34.9
Dividend Yield (%)	1.2	1.2	1.4	1.6	1.7
Book Value	231.6	228.9	224.7	275.8	330.1
Dividend Payout Ratio (excl DT)	42.4	37.2	35.1	36.0	35.8
Return ratios (%)					
RoE	32.4	29.3	36.2	36.0	31.5
RoCE	33.7	30.7	37.2	37.9	33.1
Pre Tax ROIC	60.8	57.3	61.7	61.5	61.1
Tunover Ratios					
Asset Turnover Ratio	1.1	1.1	1.3	1.2	1.1
Debtor Days (incl. unbilled Rev)	87	95	87	87	86
Working Capital Cycle Days	64	63	77	75	74
Valuation ratios (x)					
PER	30.6	30.4	24.6	22.2	20.9
P/BV	8.8	8.9	9.1	7.4	6.2
EV/EBTDA	24.1	23.9	19.3	17.5	16.9
EV/Sales	6.6	6.3	5.3	4.8	4.6
M-cap/Sales	6.6	6.3	5.4	4.8	4.6

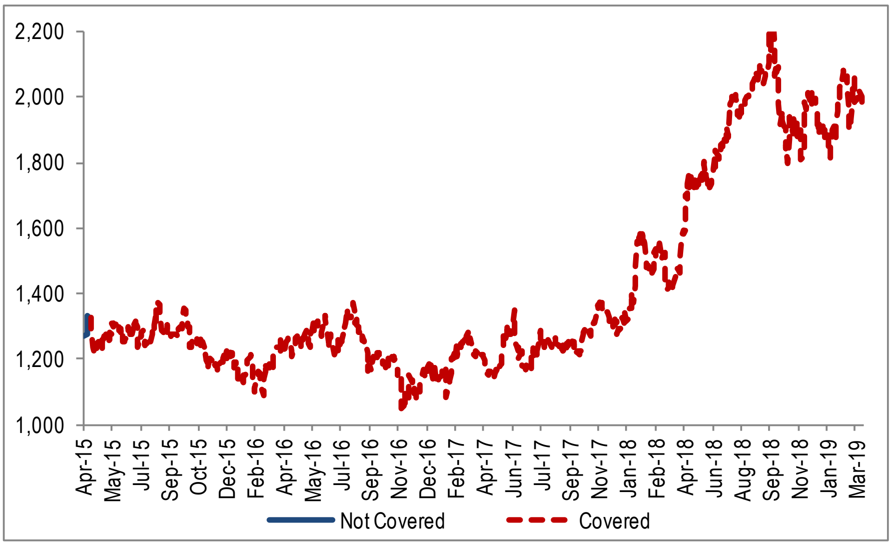
Source: Company, Nirmal Bang Institutional Equities Research

Rating track

Date	Rating	Market price (Rs)	Target price (Rs)
13 April 2015	Sell	2,619	2,314
17 April 2015	Sell	2,574	2,325
10 July 2015	Sell	2,529	2,173
9 September 2015	Sell	2,540	2,173
5 October 2015	Sell	2,641	2,217
14 October 2015	Sell	2,599	2,248
8 January 2016	Under Review	2,398	-
13 January 2016	Under Review	2,327	-
14 March 2016	Sell	2,360	2,055
20 April 2016	Sell	2,520	2,089
15 July 2016	Sell	2,521	2,075
14 September 2016	Sell	2,359	2,041
14 October 2016	Sell	2,329	2,073
10 January 2017	Sell	2,304	1,952
13 January 2017	Sell	2,344	1,956
14 February 2017	Sell	2,414	1,983
21 February 2017	Sell	2,502	1,983
2 March 2017	Sell	2,477	1,983
19 April 2017	Sell	2,309	1,996
21 June 2017	Sell	2,443	1,923
14 July 2017	Sell	2,446	1,930
28 September 2017	Sell	2,475	1,908
13 October 2017	Sell	2,548	1,913
26 December 2017	Under Review	2,647	-
12 January 2018	Under Review	2,792	-
17 March 2018	Accumulate	2,829	3,155
20 April 2018	Accumulate	3,191	3,176
26 June 2018*	Accumulate	1,818	1,812
11 July 2018	Accumulate	1,876	1,862
05 October 2018	Accumulate	2,063	2,145
12 October 2018	Accumulate	1,980	2,120
27 December 2018	Sell	1,892	1,712
7 January 2019	Sell	1,877	1,533
11 January 2019	Sell	1,883	1,545
18 March 2019	Sell	2,040	1,607

* Post 1:1 bonus share issue

Rating track graph



DISCLOSURES

This Report is published by Nirmal Bang Equities Private Limited (hereinafter referred to as "NBEPL") for private circulation. NBEPL is a registered Research Analyst under SEBI (Research Analyst) Regulations, 2014 having Registration no. INH000001436. NBEPL is also a registered Stock Broker with National Stock Exchange of India Limited and BSE Limited in cash and derivatives segments.

NBEPL has other business divisions with independent research teams separated by Chinese walls, and therefore may, at times, have different or contrary views on stocks and markets.

NBEPL or its associates have not been debarred / suspended by SEBI or any other regulatory authority for accessing / dealing in securities Market. NBEPL, its associates or analyst or his relatives do not hold any financial interest in the subject company. NBEPL or its associates or Analyst do not have any conflict or material conflict of interest at the time of publication of the research report with the subject company. NBEPL or its associates or Analyst or his relatives do not hold beneficial ownership of 1% or more in the subject company at the end of the month immediately preceding the date of publication of this research report.

NBEPL or its associates / analyst has not received any compensation / managed or co-managed public offering of securities of the company covered by Analyst during the past twelve months. NBEPL or its associates have not received any compensation or other benefits from the company covered by Analyst or third party in connection with the research report. Analyst has not served as an officer, director or employee of Subject Company and NBEPL / analyst has not been engaged in market making activity of the subject company.

Analyst Certification: I, Girish Pai, research analyst and the author of this report, hereby certify that the views expressed in this research report accurately reflects my personal views about the subject securities, issuers, products, sectors or industries. It is also certified that no part of the compensation of the analyst was, is, or will be directly or indirectly related to the inclusion of specific recommendations or views in this research. The analyst is principally responsible for the preparation of this research report and has taken reasonable care to achieve and maintain independence and objectivity in making any recommendations.

Disclaimer

Stock Ratings Absolute Returns

BUY > 15%

ACCUMULATE -5% to15%

SELL < -5%

This report is for the personal information of the authorized recipient and does not construe to be any investment, legal or taxation advice to you. NBEPL is not soliciting any action based upon it. Nothing in this research shall be construed as a solicitation to buy or sell any security or product, or to engage in or refrain from engaging in any such transaction. In preparing this research, we did not take into account the investment objectives, financial situation and particular needs of the reader.

This research has been prepared for the general use of the clients of NBEPL and must not be copied, either in whole or in part, or distributed or redistributed to any other person in any form. If you are not the intended recipient you must not use or disclose the information in this research in any way. Though disseminated to all the customers simultaneously, not all customers may receive this report at the same time. NBEPL will not treat recipients as customers by virtue of their receiving this report. This report is not directed or intended for distribution to or use by any person or entity resident in a state, country or any jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject NBEPL & its group companies to registration or licensing requirements within such jurisdictions.

The report is based on the information obtained from sources believed to be reliable, but we do not make any representation or warranty that it is accurate, complete or up-to-date and it should not be relied upon as such. We accept no obligation to correct or update the information or opinions in it. NBEPL or any of its affiliates or employees shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. NBEPL or any of its affiliates or employees do not provide, at any time, any express or implied warranty of any kind, regarding any matter pertaining to this report, including without limitation the implied warranties of merchantability, fitness for a particular purpose, and non-infringement. The recipients of this report should rely on their own investigations.

This information is subject to change without any prior notice. NBEPL reserves its absolute discretion and right to make or refrain from making modifications and alterations to this statement from time to time. Nevertheless, NBEPL is committed to providing independent and transparent recommendations to its clients, and would be happy to provide information in response to specific client queries.

Before making an investment decision on the basis of this research, the reader needs to consider, with or without the assistance of an adviser, whether the advice is appropriate in light of their particular investment needs, objectives and financial circumstances. There are risks involved in securities trading. The price of securities can and does fluctuate, and an individual security may even become valueless. International investors are reminded of the additional risks inherent in international investments, such as currency fluctuations and international stock market or economic conditions, which may adversely affect the value of the investment. Opinions expressed are subject to change without any notice. Neither the company nor the director or the employees of NBEPL accept any liability whatsoever for any direct, indirect, consequential or other loss arising from any use of this research and/or further communication in relation to this research. Here it may be noted that neither NBEPL, nor its directors, employees, agents or representatives shall be liable for any damages whether direct or indirect, incidental, special or consequential including lost revenue or lost profit that may arise from or in connection with the use of the information contained in this report.

Our reports are also available on our website www.nirmalbang.com

Access all our reports on Bloomberg, Thomson Reuters and Factset.

Team Details:

Name		Email Id	Direct Line
Rahul Arora	CEO	rahul.arora@nirmalbang.com	-
Girish Pai	Head of Research	girish.pai@nirmalbang.com	+91 22 6273 8017 / 18
Dealing			
Ravi Jagtiani	Dealing Desk	ravi.jagtiani@nirmalbang.com	+91 22 6273 8230, +91 22 6636 8833
Pradeep Kasat	Dealing Desk	pradeep.kasat@nirmalbang.com	+91 22 6273 8100/8101, +91 22 6636 8831
Michael Pillai	Dealing Desk	michael.pillai@nirmalbang.com	+91 22 6273 8102/8103, +91 22 6636 8830

Nirmal Bang Equities Pvt. Ltd.

Correspondence Address

B-2, 301/302, Marathon Innova,

Nr. Peninsula Corporate Park,

Lower Parel (W), Mumbai-400013.

Board No. : 91 22 6273 8000/1; Fax. : 022 6273 8010