Tata Consultancy Services (TCS)

Issue Summary

• **Type**	Public issue, 100% book building	• **Min. subscription**	7 shares
• **Size**	Rs 43 bn to Rs 50 bn	• **Lead Managers**	JM Morgan Stanley, DSP Merrill Lynch, JP Morgan
• **Price**	Rs 775 to Rs 900 per share	• **Listing**	BSE & NSE
• **Face value**	Re 1 per share	• **Promoters**	Tata Sons Limited
• **Shares on offer**	55.45 million	• **Promoters post issue holding**	82.7%
• **Issue Opens**	July 29, 2004	• **Issue Closes**	August 5, 2004

Issue structure

	QIBs	Non-Institutional Investors	Retail Portion
Number of shares	29,944,410	7,486,090	12,476,840
% of net offer to public (non-employees)*	60%	15%	25%
Minimum Bid/Application size	Rs 50,001	Rs 50,001	7 shares
In multiples of	7 shares	7 shares	7 shares
Maximum Bid/Application size	Not exceeding the size of the offer	Not exceeding the size of the offer	Rs 50,000

* 10% of shares on offer are reserved for employees of TCS

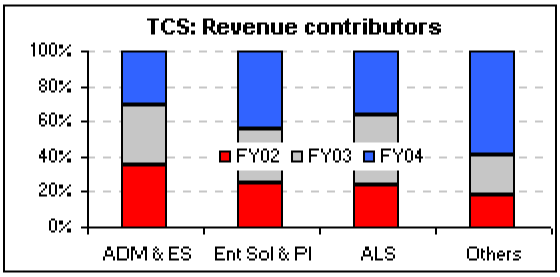
Objects of the issue

- To create a public trading market for the equity shares of the company by listing them on the stock exchanges.
- To utilise net proceeds of the fresh issue to pay transfer consideration of Rs 23 bn to Tata Sons.

Background

Business

TCS is the largest software services exporter from India, ahead of the likes of Infosys and Wipro. In FY03, it became the first Indian software company to cross the coveted US$ 1 bn revenue mark. While it was operating as a division of Tata Sons till now, post the public issue, TCS will operate as a separate entity and would be renamed - TCS Limited. The company has a wide range of offerings and caters to industries like banking, insurance and financial services (40% of revenues), manufacturing (20%), telecom, (16%) and retail (7%).



Promoters

TCS is promoted by Tata Sons, which holds around 90% of the outstanding pre-offer equity shares. The principal business of Tata Sons is investment holding and TCS is one of its major operating divisions. In addition to the TCS division, Tata Sons has three other operating divisions:

- Tata Economic Consultancy Services
- Tata Financial Services
- Tata Quality Management Services

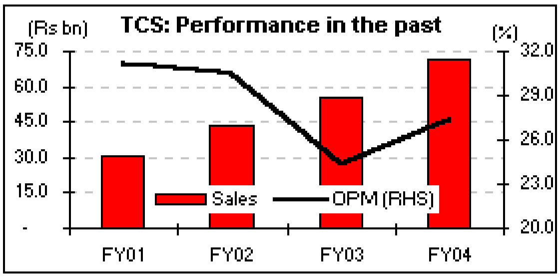
The equity shares of Tata Sons are not listed on any stock exchange. Charitable trusts hold the largest portion (around 66%) of its outstanding equity shares.

- **Sector**

  Global technology spending seems to be on an up-trend after the past couple of years of slowdown. However, the demand seems to be shifting from low-end services to high-end ones, like IT consulting, package implementation and systems integration. While Indian software companies are increasingly facing competition from global MNCs who are replicating the Indian offshoring model, the need of the hour for them (the Indian companies) is to rapidly move up the software value chain. For the Indian software industry, one of the biggest concerns in the medium term is the outsourcing backlash in the US. However, to grow in the long-term, scalability and quality offerings would be the key.

  As per the leading IT research and consultancy firm, Gartner, total worldwide IT services spending is expected to grow from US$ 535 bn in 2002 to US$ 727 bn by 2007, a CAGR growth of 6.3%. Also, as per NASSCOM, India's software services exports grew by 25% in FY04, from US$ 9.6 bn to US$ 12.5 bn. This represents a mere 1.6% of the global IT services market. NASSCOM also expects Indian IT services exports to cross the US$ 56 bn mark by FY08, which would mean CAGR growth of over 45% in the four-year period (FY04-FY08). Both these factors combine to provide Indian software companies a huge growth potential going forward.

Reasons to apply



- **Management experience:** Like Infosys, this parameter is the biggest strength for TCS. And it is well indicated by the rapid growth of the company in the past. To put things in perspective, TCS has grown its revenues and profits at CAGR of 33% and 27% respectively since FY01. This compares well with Infosys' CAGR of 37% and 26% respectively during the same period. Also, the management can be credited with pioneering the global delivery model at an early stage that MNCs are trying to replicate now.

- **Huge outsourcing opportunity:** With the value proposition of offshore development being well established, corporates in the West are increasingly outsourcing to Indian software companies. However, for mission critical jobs, prospective clients generally look at larger well-known companies that can provide end-to-end solutions. Software majors like TCS are likely to be the key beneficiaries of the increased demand for offshore projects. Also, with India's share in global IT services market at a low of around 1.6% and the global IT services market expected to grow at a CAGR of over 6% till 2008, there is a huge potential for Indian software companies to garner larger long-term clients and grow rapidly going forward. As a matter of fact, TCS is increasingly getting larger contracts from its clients. For instance, the number of clients having more than US$ 50 m and US$ 20 m billings grew from 2 and 8 respectively in FY02 to 4 and 16 in FY04.

- **Scale advantage:** A large balance sheet size is a key competitive differentiator in the global IT services market. This is because clients, to benefit from economies of scale, generally prefer large vendors for outsourcing their IT requirements. TCS scores high on this account, as it is the largest software services exporter from India. Also, to meet clients' end-to-end IT requirements, the company has on offer a wide range of services, some of which are software development and maintenance, package implementation, consulting and IT-enabled services. Over that, the large size and ability to deliver quality services has helped TCS in cementing long-term relationships with some large MNCs. For instance, the company has over 10 year relationships each with the GE Group and P&O Nedlloyd.

- **Low attrition:** In the wake of increasing competition for talent, the average attrition rate for the Indian IT industry is high at around 16%-17%. However, the figure for TCS stands at a remarkably low 6.1% in FY04. Apart from being lower than the industry average, this rate is also favourable compared to its peers like Infosys and Satyam that had attrition rates of 10% and 17% respectively in FY04. Attracting and, especially, retaining key employees, plays a decisive role in an IT services company growth. Apart from helping in maintaining a common culture without much disturbances, a high retention rate also helps in keeping down training costs, thus helping an IT services company grow its profitability faster. Going forward, if TCS manages to keep the attrition rate lower at the current levels, it will be of immense benefit to the company's growth prospects.

- **Less leveraged on the US:** TCS, unlike its domestic peers like Infosys (71%) and Satyam (73%), derives a relatively lower proportion (62%) of its total revenues from the US markets. This is a positive, in the sense that a lower revenue share from a single region helps the company de-risk its business from unforeseen contingencies arising in that particular region.

Reasons not to apply

- **Where is the cash?** TCS will have to pay Rs 23 bn out of the net proceeds of the fresh issue to Tata Sons as consideration for transfer of business. But where is the cash to make the payment?

  The TCS issue has two parts to it. Out of the 55.4 m shares on offer, around 32.7 m shares are offer for sale by Tata Sons, the money generated from which will go straight to its books and not add to TCS' balance sheet. The remaining, i.e., the fresh issue of 22.7 m shares, even if offered at the highest price of Rs 900 per share, will amount to only Rs 20 bn. Now, when we add another Rs 1.6 bn cash that TCS has on its books at the end of FY04, there is a shortfall of Rs 1.4 bn (Rs 23 bn *minus* Rs 20 bn *minus* Rs 1.6 bn). This means that TCS will have to resort to using cash generated in the latest quarter (1QFY05) to pay Tata Sons the complete due amount. When that happens, TCS (as a separate entity) will have almost negligible amount of cash on its books. We believe that this is a big negative as that would hinder the company's investment plans, at least till it generates sufficient cash going forward. This compares poorly with the company's peers, Infosys and Satyam, which had cash balances of Rs 17 bn and Rs 18 bn respectively at the end of FY04.

- **Decreasing cost advantage:** In the software services business, Indian companies traditionally have had a cost advantage over their Western competitors in markets like the US and Europe. However, the downturn in the US economy forced these companies to trim billing rates to compete with Indian software companies. Also, unable to beat competition on the pricing front, global IT services majors are consistently setting up bases in India. This has not only threatened Indian IT industry's cost leadership, Indian software companies have also been made to face intense competition for talent. All these pressures mean stagnant billing rates and higher employee costs going forward. In line with the industry, this may also affect TCS' margins and, consequently, the profitability going forward.

- **Political concerns:** Backlash in the US against outsourcing of jobs to low-cost countries like India has raised some medium-term concerns for companies like TCS that have significant business emanating from the US. While we believe that over the long-term, sound economics is more likely to take the front seat, near term concerns can have serious effects on valuations of the sector and consequently, of the company.

- **Conflict of interest:** TCS' promoter group, Tata Sons, also holds interest in Tata Infotech (74%) and Tata Elxsi (38%), both of whom are engaged in software services business. Further, there is Tata Technologies, a subsidiary of Tata Motors, which provides specialized IT services in niche markets. Also, a number of directors of Tata Sons are on the boards of the other Tata-affiliated companies in the IT services industry. As such, there are risks of conflict of interest within these Group companies.

Financial Performance

(Rs m)	FY01	FY02	FY03	FY04
Sales	30,567	43,706	55,179	71,227
Other income	727	959	780	937
Total income	31,294	44,665	55,959	72,164
Expenditure	21,031	30,383	41,716	51,799
Operating profit	9,536	13,323	13,463	19,428
OPM (%)	31.2%	30.5%	24.4%	27.3%
Depreciation	631	793	1,039	1,331
Profit before tax	9,632	13,489	13,204	19,034
Tax	1,927	2,568	2,445	2,884
Net profit	7,705	10,922	10,759	16,150
Minority interest	-	55	(79)	(125)
Equity in affiliates	79	65	48	100
Extraordinary item	-	-	211	-
Net Profit after adjustments	7,784	11,042	10,939	16,125
NPM (%)	25.5%	25.3%	19.8%	22.6%
No. of shares	455.5	455.5	455.5	455.5
EPS (Rs)	17.1	24.2	24.0	35.4

*Consolidated as per US GAAP

TCS Vs Infosys

- **Onsite-Offshore:** Onsite revenues have a higher contribution in TCS' consolidated revenues as compared to Infosys. While the former derives 64% of its revenues from onsite services, the figure for Infosys stands at 55%. This is largely the reason for TCS' lower operating margins compared to Infosys. However, the company seems to be lowering this contribution, as seen from the past three years' data. Onsite contribution in FY02, FY03 and FY04 were 71%, 66% and 64% respectively.

- **Revenue per client:** TCS scores over Infosys on this front. This is because onsite services commands relatively higher billing rates than offshore services.

- **Revenue per employee:** TCS has an upper hand on this front as well. And the reason seems to be the same - relatively high onsite presence.

- **Geographical break-up:** TCS derives a lower percent (62%) of its consolidated revenues from the North American markets as compared to Infosys (71%). This is a positive for TCS as lower revenue share from a single region helps the company de-risk its business from unforeseen contingencies arising in that particular region.

- **Nature of contracts:** TCS earns a higher proportion (56%) of its revenues from fixed price-fixed time projects when compared to Infosys (34%). This might be a

Comparative parameters

(FY04)	TCS	Infosys
Sales growth (YoY, %)	29.1	33.3
Profits growth (YoY, %)	47.4	30.3
Operating margins (%)	27.3	32.9
North America's share (% of sales)	62.2	71.2
Onsite presence (% of sales)	63.8	55.1
Revenue per client (Rs m)	130.0	123.5
No. of clients (Nos.)	548	393
Revenue per employee (Rs m)	2.4	1.9
Profit per employee (Rs m)	0.5	0.5
No. of employees (Nos.)	30,121	25,634

negative in the sense that if these contracts are not completed within the specified time and costs, they might result in increased liability for the company, thus affecting profitability.

Comparative valuations and comments

At the higher offer price of Rs 900, TCS' offer has a P/E valuation of 25.4x FY04 EPS. This is at a discount to Infosys current valuation of 31.2x based on its FY04 EPS. However, since TCS has a lower profitability as compared to Infosys, it would deserve valuations that are slightly at a discount to what Infosys is accorded. Considering the fact that TCS' margins are likely to stabilise at around the current levels and those for Infosys are likely to fall further, we believe that TCS' offer price is attractive from a long-term (more than 2 years) perspective. However, the cash deficiency is a big concern, atleast in the near term.

Comparative valuations

	TCS	Infosys	Satyam
Price (Rs)	900	1,448	326
P/E (x)	25.4	31.2	20.4
P/Sales (x)	5.8	8.0	4.1
OPM (%)	27.3	32.9	26.5
NPM (%)	22.6	26.1	20.1

Shareholding

(%)	Pre-Offer	Post-Offer
Promoter Group - Tata Sons	90.0	82.7
Other entities of the Promoter Group	7.9	4.2
Others	2.1	1.5
Public	-	11.6
Total	100.0	100.0