FLASH

TCS Enters 2016 Poised for Another Strong Year

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IN THIS FLASH

This IDC Flash looks at TCS, which in January 2016 released its 3Q16 results for the three months to December 31, 2015. This Flash aggregates the four published TCS financial results covering calendar 2015 to create a picture of how the vendor progressed during the year.

SITUATION OVERVIEW

In January 2016, TCS released its results for its FY16 third quarter ending December 31, 2015. Revenues in the quarter grew 7.7% in dollar terms to $4,145 million, on a healthy operating margin of 26.6%. Net operating cash flow was strong in the quarter, at $994 million, the equivalent of 24% of revenues. Attrition in the core IT services business, excluding the U.K.-based Diligenta BPO operation, was 15.3% on a LTM (last 12 months) basis, up from 13.4% in calendar 4Q15. Executives reported pricing as being "largely stable" and said that revenues from "digital" work were roughly 13.7% of total revenues in calendar 4Q15.

TCS' financial year ends on March 31, but if we combine the four quarterly results published by TCS relating to calendar 2015, we can construct a set of "calendarized" results for 2015. Based on this, by our estimate:

- Global revenues grew by 7.8% in dollar terms in calendar 2015 to $16.2 billion, on an operating margin down three percentage points at 24.2%. (Growth in local currencies will have been higher because the dollar strengthened against the euro and the pound; a rough estimate is that local currency growth was about 11%). Net operating cash flow was healthy and stable at around $3.4 billion, representing just under 21% of revenues.
- Revenues in the Americas grew 10% in dollar terms to just under $8.6 billion, with the growth likely to be very similar in constant currency. Revenues in the U.K. grew only 1.1% in dollar terms to just over $2.6 billion, but in local currency the growth was more like 8.9%. Growth in Continental Europe was last in dollar terms, but in euro terms (a close proxy for local currency) growth was strong at about 19.5%.
- By service line, growth was once again strongest in Infrastructure Services, which grew by about 21% in dollar terms to reach $2.4 billion globally. The second-highest growth area was Asset Leveraged Solutions, which grew just over 19% to $440 million globally. The core Application Development and Maintenance business grew relatively slowly, at about 6.8%, reaching just under $6.1 billion, while the second-largest business, Enterprise Solutions, grew faster than average at 8.5%, reaching just over $2.5 billion. Business Process Services was the weakest performer, growing 5.6% globally to just under $1.9 billion, held back by declining demand in the U.K.-based Diligenta life and pensions BPO business.
- Attrition in the IT services business remained fairly stable during 2015 at around 15% for most of the year, versus an average of about 12% during calendar 2015.

Overall, in 2015, TCS managed respectable growth (the global constant currency rate would almost certainly have been several percentage points higher than the dollar-terms 7.8% rate), and while margins were down about three points, at over 24% they are high enough to support TCS' insistence that it's not giving away business.

FUTURE OUTLOOK

What of 2016? TCS refuses to give revenue guidance, but executives said they had no indication from conversations with customers that budgets would be lowered in 2016 and added that "the demand environment in Europe or the U.S. etc. remains positive." Executives said on the call that revenues would have been higher in calendar but for four main "headwinds" dampening down demand: conditions in Latin America, Japan, Diligenta, and the energy vertical. Of these four areas, only Japan is expected to remain a possible revenue-growth inhibitor after calendar 1Q16.

Globally, these results are likely to cement TCS' status as a top 10 services vendor when IDC produces its ranking tables for 2015. In the U.K., local-currency growth of almost 9% takes TCS closer to its goal of being a £2 billon player in the country. TCS is not merely a tier 1 player in the U.K. but is one of the geography's strongest brands, up there with IBM, HP, Accenture, and so on. It crossed the symbolic £1 billion total revenue barrier in the U.K. in 2012 and if it can manage just another two years of growth at the level it experienced in 2015, it will cross the £2 billion revenue barrier in the U.K. in 2017. The Diligenta BPO business remains a problem for TCS and overall the unit looks like a bet that was worth taking but just didn't work out as anticipated.

If revenues of the fast-growing Infrastructure Services business were to continue at the high pace of 2015, and if Enterprise Solutions was similarly to repeat its 2015 growth rate this year, Infrastructure Services would overtake Enterprise Solutions to become TCS' second-largest service line globally in calendar 2016. That may not actually happen this year, given that the infrastructure unit's 21% growth rate in 2015 was about seven percentage points lower than the equivalent rate in 2014, and this year may see another fall as the "law of large numbers" kicks in. But at over $2.5 billion in size and still rapidly growing, TCS' Infrastructure Services is a force to be reckoned with, and will be the company's second-largest service line at some point soon.

With the growth in demand among clients for "digital" services — which equate roughly to what IDC calls 3rd Platform services — comes an obvious fear that demand for IT services will tail off because cloud-based services demanded by clients will require far less effort than on-premise software to implement and to support. Moreover, digital projects tend to be more iterative and phased than traditional IT projects, which should put downward pressure on spend. As TCS Chief Executive N Chandrasekaran told analysts on the calendar 4Q15 results call: "The way these [digital] engagements get done is that a large chunk of budget is allocated within the company, but across a number of small projects. It won't be like you sign a single large contract which is a big size."

It's certainly the case that digital engagements are more phased and iterative, but cloud software implementations need not be substantially smaller than on-premise engagements in like-for-like terms. Implementing and then supporting enterprisewide cloud software is a more demanding task than clients thought a few years ago when they started to implement departmental cloud software (think early Salesforce implementations in sales, or Workday implementations in HR). Now that cloud software implementations are scaling up and encompassing the entire enterprise (e.g., implementation of cloud ERP suites) and now that multiple cloud software products have to be integrated within the enterprise, the need for outside help increases rapidly. As Chandra said: "Digital transformation is leading to many opportunities and I believe that we have a great opportunity in front of us."

Looking to the future, TCS needs to find more "non-linear" business models that decouple demand for services from demand for headcount. In part of course that means deploying traditional productivity enhancement techniques such as automation accelerators, tools, and so on. But more importantly TCS has been investing in intellectual property based offerings that it hopes will drive non-linear growth in the future, notably the software products (Asset Leveraged Solutions); platform-based BPO services (Process Clouds); and its India-focused iON offering, which sells IT as a service to small and medium-sized businesses.

TCS has yet to see these non-linear initiatives achieve substantial scale. While Asset Leveraged Solutions grew strongly in 2015 (up 19% to $440 million, by our calculations) it's still a smaller percentage of TCS (2.8% of total revenues in calendar 4Q15) than it was five years ago. TCS is not, however, standing still and it has launched a series of "digital platforms," including Croma (HR), TAP (accounts payable), Intelligent Urban Exchange (smart cities), Customer Insights, Optumera (digital merchandising), Active Archive (Hadoop-based data archiving), and ignio (neural automation) that take the non-linear growth model into the emerging "digital" space. These are bold initiatives and IDC believes they are the right moves for TCS, but they will take time to come to fruition. Although TCS executives said the new platforms are "gaining traction," the revenues associated with them are still tiny and the CEO himself told analysts on the result call that "ignio still needs to get a lot more clients and we need to get many more implementations before we can talk about material revenue growth on that platform."

Much of TCS' revenue growth in 2015 was a result of the company's focus on what it calls "digital" technologies (mobility, Big Data/analytics, cloud, social, artificial intelligence) — not just in the context of technology transformation, but more importantly in the broader context of business transformation (or "digital reimagination" as it terms it). TCS has made significant investments in the digital space, which include consulting and IT services frameworks and offerings, labs, technology partnerships, and open innovation networks (see *Continuous Innovation Supports Digital Reimagination at TCS Europe*, IDC #ADS55X, August 2015). We'd expect to see these investments continue this year — as seen, for example, in the Digital Reimagination Studio launched in Silicon Valley in February 2016.

Speaking of consulting, we would continue to flag this area as a priority for investment by TCS in 2016 — particularly high-end business consulting. Digital is about business, not "just" technology, and driving digital transformation means having strong business consulting capabilities. This is an area where TCS should continue to invest more on a global scale. As we said a year ago, commenting on Europe (see *TCS' Digital Reimagination and Localization Strategy Underlines its Path to Growth in France/Europe*, IDC #Q52X, February 2015): "The key challenge for TCS is to get beyond its 'IT partner status' and be accepted as a true transformation partner. […] TCS' business consulting and business transformation capabilities are still new, and the company will need to invest more in business consulting as it is the spearhead to address business stakeholders and win transformation projects." TCS did strengthen its transformation story in 2015, as we detailed above. In IDC's view it still needs to present itself more strongly to the market as a leading business consultancy as well as a tier 1 global IT services player.

Overall, TCS remains a highly driven organization with a rich vision and self-belief, and a strong focus on customers' needs and challenges, and a growing brand at CXO level. We see no change in TCS' impressive strengths versus its key competitors as it enters 2016, and we expect it to continue to gain market share during the year.

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