Cognizant Technology Solutions Corporation CTSH [Nasdaq] | ★★★

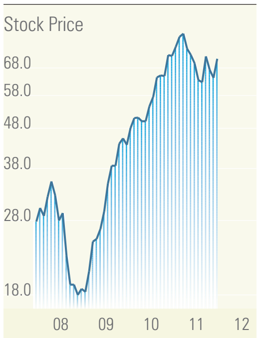
Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Stewardship	Morningstar Credit Rating	Industry
70.68 USD	68.00 USD	47.60 USD	91.80 USD	Medium	Narrow	B	—	Information Technology Services

Unfavorable Revenue Mix in Europe Could Marginally Affect Cognizant's Growth in Near Term

by Swami Shanmugasundaram
Equity Analyst
Analysts covering this company do not own its stock.

Pricing data through February 14, 2012.
Rating updated as of February 14, 2012.

Currency amounts expressed with "$" are in U.S. dollars (USD) unless otherwise denoted.



Analyst Note Feb. 09, 2012

Cognizant Technology Solutions reported fourth-quarter results that were in line with our expectations, and we are maintaining our fair value estimate.

Cognizant's large exposure to the fast-growing health-care vertical, combined with its solid execution, helped the company once again report an industry-leading growth rate in its fourth quarter. For the past few years, the company has consistently grown faster than its Tier 1 competitors. Fourth-quarter revenue increased 4% sequentially and 27% year over year to $1.66 billion. Except for its European operations, the company witnessed solid double-digit top-line growth across the board. Health-care practice again led the growth (6% sequential and 35% year over year) and we expect this to be the company's growth driver in the medium term, primarily driven by regulatory reform-related work. With respect to Europe, Cognizant's relatively poor performance (5.6% sequential decline and 8.8% year-over-year growth) could be attributed to its revenue mix. While most of its peers derive a significant part of their European revenue by providing outsourcing services, Cognizant's exposure is mostly on the discretionary side. As the European economy risks falling back into recession, many companies have cut their discretionary spending in recent months, which negatively affected Cognizant. We expect European revenue to remain under modest pressure in the near term as the company realigns its portfolio in the region.

There were hardly any surprises when it came to operating income and margin performance during the quarter. The company's adjusted operating margin came in at 20%, well within management's target of 19%-20%.

On the supply side, the pressure has eased considerably as voluntary employee attrition came in at 10.1%, compared with 16.0% in the year-ago period. Given the uncertainty in the demand environment, many companies have cut down their pace of hiring, leading to a decline in the attrition rate. With no visible signs of demand acceleration, we expect this trend to continue in the near term and wouldn't be surprised if Cognizant's attrition stays at or goes below the current levels in the coming quarters.

Thesis Oct. 06, 2011

Cognizant Technology Solutions, the youngest of the Tier 1 Indian IT service firms, was fast to get off the blocks and has increased revenue in excess of 40% annually, on average, during the last five years. Cognizant's consistent performance and fast growth is driven by its high-quality consultative approach and deep client partnerships. The company is an active player in a large and rapidly growing IT services market and possesses the highest growth profile among its Tier 1 peers.

Although Cognizant is a United States-based company, its business model closely resembles that of its Indian counterparts. However, to distinguish itself from competitors in an increasingly crowded field, Cognizant chose to build a U.S.-based management team to gain the trust of U.S. customers while delivering the cost savings of the offshore model. This strategy of using American nationals and Indians with extensive exposure to U.S. business culture for key customer-relationship roles has helped Cognizant outperform its older peers. This customer-centric focus also helped Cognizant build a significant competitive advantage as it straddles the best of consulting and outsourcing.

Cognizant derives a significant portion of its revenue from its largest clients, who generally form long-term relationships with the company. Much of Cognizant's growth thus far has been through repeat business from its existing client base, and we believe this trend will continue. Cognizant's geographic breadth, domain expertise (financial services, health care, manufacturing, and so on), and a wide range of horizontal service offerings (enterprise resource planning, business process

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Close Competitors	Currency(Mil)	Market Cap	TTM Sales	Oper Income	Net Income
Cognizant Technology Solutions Corporation	USD	21,354	5,768	1,073	850
Accenture PLC	USD	39,940	28,464	3,625	2,385
Infosys Ltd	USD	32,700	6,825	1,949	1,655
Wipro, Ltd.	USD	27,318	7,685	1,333	1,179

Morningstar data as of February 14, 2012.

outsourcing, testing, IT infrastructure services, and so on) not only act as catalysts for growth, but also shield the company from feeling the pinch of a global economic slump or weakness in any particular part of its business.

We believe that Cognizant's ability to capture market share should continue for the foreseeable future for a couple of reasons. First, Cognizant's strategy to reinvest the excess profits generated during this high-growth period to extend its range of service offerings and increase the employee bench strength while maintaining stable operating margins of 19%-20% should benefit the company in the long run. Second, Cognizant's reinvestments in the past have enabled the company to build a critical mass of technological expertise, industry-specific knowledge, and business acumen. This huge reserve of skilled labor should enable Cognizant to scale up its offerings in a short period with minimal effort. As the outsourcing market matures, offshoring services are gaining more traction in the broader IT services market. Even though many countries have emerged as attractive offshore destinations, India remains the preferred destination. This provides Cognizant, one of the dominant players in the Indian market, an excellent opportunity to expand further and garner significant market share.

A positive industry tailwind also aided Cognizant's growth. Historically, companies have aggressively pursued outsourcing in a weak economy. The current economic slowdown might force clients to turn more toward outsourcing to reduce their operating costs. This increase in business should offset any weakness in discretionary projects. Overall, we believe that Cognizant, with its world-class management team, strong recurring revenue base, and maintenance revenue streams, is well-positioned to weather the economic slowdown.

Valuation, Growth and Profitability

Our fair value estimate for Cognizant is $68 per share. We expect the company to continue to benefit from the secular trend toward offshore outsourcing. Additionally, as the company invests more to strengthen its portfolio of offerings (for example, cloud-based service offerings, analytics, and mobility), its addressable market also expands, which we believe will provide a nice tailwind over the long term. Overall, we expect growth to be broad-based across all industry verticals and geographies, and our forecast assumes compound annual growth of 16% over the next seven years. We estimate Cognizant's operating margin to remain well within management's targeted 18%-20% range during our forecasting period. We expect the company to rely on its different operating levers to effectively insulate its cost base from the impact of wage inflation and employee attrition.

Risk

Cognizant, like other IT service providers, is exposed to higher customer concentration; the company's top five and top 10 customers contribute around 20% and 30% of revenues, respectively. Given the higher switching costs and sticky nature of client-vendor relationships, it is unlikely that clients will switch service providers but the risk of client defection does exist. Cognizant is also subjected to cyclical downturns in technology spending--any weakness in the economy may force customers to cut their IT spending, hurting Cognizant's growth prospects. The Indian government has granted tax

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subsidies on Indian software exports, and as these subsidies get phased out by 2011, Cognizant's low tax rates should rise.

Bulls Say

- Cognizant is steadily expanding its roster of strategic clients--those with annual revenue potential of $5 million to $50 million--which gives it substantial recurring revenue opportunities.
- Cognizant's operating margins have held up well in the face of heightened competition, higher wage inflation/attrition, and currency fluctuations.
- Even though Cognizant is a late entrant to the fast-growing European region, it has been aggressive in its effort to increase its presence, and we believe Cognizant is well-positioned to grow in this region.

Bears Say

- The tax holiday scheme for export-driven software companies in India is set to expire in 2011, and this will likely lead to a notable uptick in the tax rate.
- Cognizant, which has a large number of clients in U.S., could face problems in attracting and retaining highly skilled foreign workers in the U.S. because of restrictions in H1B Visa availability.
- Supply-side pressures (caused by voluntary employee attrition and wage inflation) could pose risks to operating margins in the future.

Financial Overview

Financial Health: Cognizant maintains a strong balance sheet with more than $2.2 billion in cash and no debt. With Cognizant generating solid free cash flows that averaged low teens of revenue over the last five years, we expect the company to remain unleveraged in the future.

Company Overview

Profile: Based in Teaneck, N.J., Cognizant is a leading provider of offshore software development, maintenance, testing, and packaged implementation services. The company serves clients primarily in North America and Europe with a focus on the financial, health care, and retail/manufacturing/logistics industries. The core of the company's growth strategy revolves around its focus on the "fourth generation" of offshore outsourcing, which is aimed at capturing the best of both worlds--offshore outsourcing and local consulting.

Management: We believe that stewardship at Cognizant is good. Cognizant is led by CEO Francisco D'Souza, who took over in 2007 when Lakshmi Narayanan moved into the vice chairman role. D'Souza had been COO since 2003 and previously led Cognizant's North American division. D'Souza is a Cognizant veteran who has been with the firm since its inception in 1994, and we believe he provides the firm with solid leadership. John Klein, an independent director with Cognizant since 1998, was elected to serve as chairman of the board in December 2003. We are pleased that a substantial portion of the total management compensation is based on the creation of measurable shareholder value. Executives and directors collectively own 2% of Cognizant's outstanding shares, a sufficient stake, given the size of the company, in our opinion. From an operational and strategic point of view, we believe the management team is among the best in the industry. Cognizant could improve its Stewardship Grade by eliminating its staggered board structure and antitakeover provisions.

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Nov. 02, 2011

Cognizant Reported Solid Third-Quarter Results Driven by Health-Care and Manufacturing Verticals

Cognizant reported third-quarter results that came in line with our expectations. We are maintaining our fair value estimate.

Cognizant delivered third-quarter revenue of $1.6 billion, representing 7.8% sequential and 31.6% year-over-year growth. Sequential growth was mostly driven by an increase in volume, as pricing remained stable during the quarter. The company's strong showing was aided by solid performance from all of its industry segments. Health care and manufacturing led the pack, with 42% and 35% year-over-year growth, respectively. Health care has been one of the company's primary growth drivers in the recent past, and we believe the status quo will remain intact. Within health care, the company benefited from increased adoption of outsourcing in general and health-care-reform-related regulatory projects in particular. The financial services vertical (26% year-over-year growth as compared with 43% growth last year and 30% growth last quarter) lost its steam in recent quarters, but this was

Analyst Notes (continued)

along expected lines as demand from discretionary assignments related to M&A integration, risk management, and regulatory compliance wound down. During the quarter, Cognizant's adjusted operating margin remained essentially flat at 19.8%, well within the management's targeted 19%-20% range.

To meet growing demand, the company hired more than 10,000 professionals during the quarter and ended the period with more than 122,000 technical staff on its payroll. However, this was partly offset by an employee attrition rate that stood at 13.4%. A declining trend in attrition rate during the last few quarters (15.2% in the last quarter and 18.2% in the year-ago period) indicate that the supply-side pressure is easing up. This should have a positive impact on wage inflation in the medium term, in our opinion.

Cognizant's strong guidance for its fourth quarter (at least 27% year-over-year growth) indicates that the demand for IT services continues to remain resilient despite an uncertain macroeconomic environment. Management, based on their interactions with the firm's clients, commented that the overall IT services budget will likely remain flat in 2012, but they expect Cognizant to benefit from the secular shift toward offshore outsourcing.

Cognizant Technology Solutions Corporation CTSH

Sales USD Mil	Mkt Cap USD Mil	Industry	Sector
5,768	21,354	Information Technology Services	Technology

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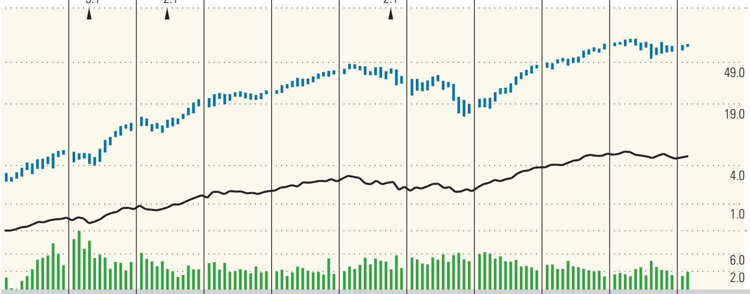
★★★	70.68	68.00	Medium	Narrow	B

per share prices in USD

6.38	12.40	21.47	26.23	41.24	47.77	37.10	46.61	74.79	83.48	74.19	Annual Price High
2.70	4.28	9.80	17.79	24.25	29.44	14.38	17.26	42.08	53.54	64.31	Low
	3:1	2:1			2:1						Recent Splits



Price Volatility
Monthly High/Low
Rel Strength to S&P 500

52 week High/Low
83.48 - 53.54

10 Year High/Low
83.48 - 2.70

Bear-Market Rank
5 (10=worst)

Trading Volume Million

Growth Rates Compound Annual

Grade: B	1 Yr	3 Yr	5 Yr	10 Yr
Revenue %	40.1	29.1	39.0	42.1
Operating Income %	39.4	31.2	37.1	41.9
Earnings/Share %	33.1	27.3	33.2	41.7
Dividends %	—	—	—	—
Book Value/Share %	32.1	32.6	35.5	44.6
Stock Total Return %	-7.5	49.5	8.4	37.1
+/- Industry	6.2	17.4	6.2	27.5
+/- Market	-8.9	31.7	9.9	35.6

Profitability Analysis

Grade: C	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	23.3	25.1	14.2	22.6
Return on Assets %	18.2	20.2	6.3	9.5
Fixed Asset Turns	9.7	7.6	9.9	7.5
Inventory Turns	—	—	12.8	16.1
Revenue/Employee USD K	55.5	43.9*	—	1050.9
Gross Margin %	42.3	43.6	28.5	38.3
Operating Margin %	18.6	18.4	6.2	16.7
Net Margin %	14.7	16.1	5.0	11.2
Free Cash Flow/Rev %	12.9	11.6	7.8	0.1
R&D/Rev %	—	—	—	9.7

Financial Position

Grade: A	12-10 USD Mil	09-11 USD Mil
Cash	1541	1181
Inventories	—	—
Receivables	1014	1268
Current Assets	3518	3812
Fixed Assets	570	665
Intangibles	309	392
Total Assets	4583	5104
Payables	75	78
Short-Term Debt	—	—
Current Liabilities	931	1041
Long-Term Debt	—	—
Total Liabilities	999	1165
Total Equity	3584	3940

Stock Performance

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	YTD	Stock Performance
76.3	89.5	85.5	18.8	53.5	-12.0	-46.8	151.0	61.7	-12.3	9.9	Total Return %
99.7	63.1	76.5	15.8	39.9	-15.5	-8.3	127.6	48.9	-12.3	2.5	+/- Market
93.2	43.5	51.2	21.4	24.7	-5.4	-4.1	37.9	33.1	13.2	-1.3	+/- Industry
—	—	—	—	—	—	—	—	—	—	0.0	Dividend Yield %
1455	2916	5628	6948	10941	9855	5259	13473	22276	19429	21354	Market Cap USD Mil

Financials

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	TTM	Financials
178	229	368	587	886	1424	2136	2816	3279	4592	5768	Revenue USD Mil
48.9	46.4	45.8	45.5	45.8	44.7	43.5	44.2	43.6	42.2	42.3	Gross Margin %
36	45	72	118	178	259	382	517	618	862	1073	Oper Income USD Mil
20.0	19.7	19.6	20.0	20.1	18.2	17.9	18.3	18.9	18.8	18.6	Operating Margin %
22	35	57	100	166	233	350	431	535	734	850	Net Income USD Mil
—	0.14	0.21	0.35	0.57	0.78	1.15	1.44	1.78	2.37	2.73	Earnings Per Share USD
—	—	—	—	—	—	—	—	—	—	—	Dividends USD
—	255	272	285	294	301	304	299	301	309	311	Shares Mil
0.68	1.07	1.71	2.58	3.79	5.06	6.75	8.93	11.79	13.04	13.04	Book Value Per Share USD
32	57	80	127	160	253	344	430	672	765	982	Oper Cash Flow USD Mil
-15	-22	-30	-47	-72	-105	-182	-169	-77	-186	-238	Cap Spending USD Mil
17	34	50	81	88	148	162	260	596	579	744	Free Cash Flow USD Mil

Profitability

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	TTM	Profitability
—	18.4	19.4	21.5	23.1	21.2	22.1	20.4	18.7	18.5	18.2	Return on Assets %
—	26.2	26.1	27.6	28.5	26.0	27.6	25.1	23.2	23.5	23.3	Return on Equity %
12.5	15.1	15.6	17.1	18.8	16.3	16.4	15.3	16.3	16.0	14.7	Net Margin %
—	1.22	1.24	1.26	1.23	1.30	1.35	1.34	1.15	1.16	1.23	Asset Turnover
—	1.4	1.3	1.3	1.2	1.2	1.3	1.2	1.3	1.3	1.3	Financial Leverage

Financial Health

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	09-11	Financial Health
96	134	216	339	508	791	902	1081	1661	2588	2771	Working Capital USD Mil
—	—	—	—	—	—	—	—	—	—	—	Long-Term Debt USD Mil
99	165	274	454	714	1074	1468	1966	2653	3584	3940	Total Equity USD Mil
—	—	—	—	—	—	—	—	—	—	—	Debt/Equity

Valuation

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	TTM	Valuation
44.3	54.4	60.6	44.4	49.8	29.5	12.6	25.4	31.0	23.5	25.9	Price/Earnings
—	—	—	—	—	—	—	—	—	1.3	1.8	P/E vs. Market
6.7	8.4	10.3	8.3	8.1	4.8	1.9	4.2	4.9	3.5	3.8	Price/Sales
8.8	10.6	12.4	9.7	10.2	6.7	2.7	5.1	6.2	4.9	5.4	Price/Book
27.0	38.8	47.4	45.9	45.7	29.9	12.6	20.3	29.7	20.4	22.4	Price/Cash Flow

Valuation Analysis

	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	25.9	24.4	47.9	14.6
Forward P/E	17.2	—	—	13.4
Price/Cash Flow	22.4	22.6	12.1	7.4
Price/Free Cash Flow	29.6	34.7	17.8	17.0
Dividend Yield %	—	—	1.0	2.0
Price/Book	5.4	5.1	4.9	2.0
Price/Sales	3.8	3.9	1.6	1.2
PEG Ratio	0.9	—	—	1.5

Quarterly Results

Revenue USD Mil	Dec 10	Mar 11	Jun 11	Sep 11
Most Recent Period	1310.6	1371.3	1485.2	1601.0
Prior Year Period	902.7	959.7	1105.2	1216.9

Rev Growth %	Dec 10	Mar 11	Jun 11	Sep 11
Most Recent Period	45.2	42.9	34.4	31.6
Prior Year Period	19.9	28.7	42.3	42.6

Earnings Per Share USD	Dec 10	Mar 11	Jun 11	Sep 11
Most Recent Period	0.66	0.67	0.67	0.73
Prior Year Period	0.48	0.49	0.56	0.66

Industry Peers by Market Cap

	Mkt Cap USD Mil	Rev USD Mil	P/E	ROE%
Cognizant Technology	21354	5768	25.9	23.3
Accenture PLC	39940	28464	17.8	71.5
Infosys Ltd	32700	6825	19.8	28.6

Major Fund Holders

	% of shares
	—
	—
	—
	—

*3Yr Avg data is displayed in place of 5Yr Avg

TTM data based on rolling quarterly data if available; otherwise most recent annual data shown.

Morningstar's Approach to Rating Stocks

Our Key Investing Concepts

- Economic Moat™ Rating
- Discounted Cash Flow
- Discount Rate
- Fair Value
- Uncertainty
- Margin of Safety
- Consider Buying/Consider Selling
- Stewardship Grades

At Morningstar, we evaluate stocks as pieces of a business, not as pieces of paper. We think that purchasing shares of superior businesses at discounts to their intrinsic value and allowing them to compound their value over long periods of time is the surest way to create wealth in the stock market.

We rate stocks 1 through 5 stars, with 5 the best and 1 the worst. Our star rating is based on our analyst's estimate of how much a company's business is worth per share. Our analysts arrive at this "fair value estimate" by forecasting how much excess cash--or "free cash flow"--the firm will generate in the future, and then adjusting the total for timing and risk. Cash generated next year is worth more than cash generated several years down the road, and cash from a stable and consistently profitable business is worth more than cash from a cyclical or unsteady business.

Stocks trading at meaningful discounts to our fair value estimates will receive high star ratings. For high-quality businesses, we require a smaller discount than for mediocre ones, for a simple reason: We have more confidence in our cash-flow forecasts for strong companies, and thus in our value estimates. If a stock's market price is significantly above our fair value estimate, it will receive a low star rating, no matter how wonderful we think the business is. Even the best company is a bad deal if an investor overpays for its shares.

Our fair value estimates don't change very often, but market prices do. So, a stock may gain or lose stars based just on movement in the share price. If we think a stock's fair value is $50, and the shares decline to $40 without much change in the value of the business, the star rating will go up. Our estimate of what the business is worth hasn't changed, but the shares are more attractive as an investment at $40 than they were at $50.

Because we focus on the long-term value of businesses, rather than short-term movements in stock prices, at times we may appear out of step with the overall stock market. When stocks are high, relatively few will receive our highest rating of 5 stars. But when the market tumbles, many more will likely garner 5 stars. Although you might expect to see more 5-star stocks as the market rises, we find assets more attractive when they're cheap.

We calculate our star ratings nightly after the markets close, and issue them the following business day, which is why the rating date on our reports will always be the previous business day. We update the text of our reports as new information becomes available, usually about once or twice per quarter. That is why you'll see two dates on every Morningstar stock report. Of course, we monitor market events and all of our stocks every business day, so our ratings always reflect our analyst's current opinion.

Economic Moat™ Rating

The Economic Moat™ Rating is our assessment of a firm's ability to earn returns consistently above its cost of capital in the future, usually by virtue of some competitive advantage. Competition tends to drive down such

Morningstar Research Methodology for Valuing Companies

Competitive Analysis → **Economic Moat™ Rating** → Company Valuation → **Fair Value Estimate** → Uncertainty Assessment → ★★★★★

Competitive Analysis: Analyst conducts company and industry research:

- Management interviews
- Conference calls
- Trade-show visits
- Competitor, supplier, distributor, and customer interviews

Economic Moat™ Rating: The depth of the firm's competitive advantage is rated:

- None
- Narrow
- Wide

Company Valuation: Analyst considers company financial statements and competitive position to forecast future cash flows.

Assumptions are input into a discounted cash-flow model.

Fair Value Estimate: DCF model leads to the firm's Fair Value Estimate, which anchors the rating framework.

Uncertainty Assessment: An uncertainty assessment establishes the margin of safety required for the stock rating.

★★★★★:

★
★★
★★★
★★★★
★★★★★

The current stock price relative to fair value, adjusted for uncertainty, determines the rating.

economic profits, but companies that can earn them for an extended time by creating a competitive advantage possess an Economic Moat. We see these companies as superior investments.

Discounted Cash Flow

This is a method for valuing companies that involves projecting the amount of cash a business will generate in the future, subtracting the amount of cash that the company will need to reinvest in its business, and using the result to calculate the worth of the firm. We use this technique to value nearly all of the companies we cover.

Discount Rate

We use this number to adjust the value of our forecasted cash flows for the risk that they may not materialize. For a profitable company in a steady line of business, we'll use a lower discount rate, also known as "cost of capital," than for a firm in a cyclical business with fierce competition, since there's less risk clouding the firm's future.

Fair Value

This is the output of our discounted cash-flow valuation models, and is our per-share estimate of a company's intrinsic worth. We adjust our fair values for off-balance sheet liabilities or assets that a firm might have--for example, we deduct from a company's fair value if it has issued a lot of stock options or has an under-funded pension plan. Our fair value estimate differs from a "target price" in two ways. First, it's an estimate of what the business is worth, whereas a price target typically reflects what other investors may pay for the stock. Second, it's a long-term estimate, whereas price targets generally focus on the next two to 12 months.

Uncertainty

To generate the Morningstar Uncertainty Rating, analysts consider factors such as sales predictability, operating leverage, and financial leverage. Analysts then classify their ability to bound the fair value estimate for the stock into one of several uncertainty levels: Low, Medium, High, Very High, or Extreme. The greater the level of uncertainty, the greater the discount to fair value required before a stock can earn 5 stars, and the greater the premium to fair value before a stock earns a 1-star rating.

Margin of Safety

This is the discount to fair value we would require before recommending a stock. We think it's always prudent to buy stocks for less than they're worth.The margin of safety is like an insurance policy that protects investors from bad news or overly optimistic fair value estimates. We require larger margins of safety for less predictable stocks, and smaller margins of safety for more predictable stocks.

Consider Buying/Consider Selling

The consider buying price is the price at which a stock would be rated 5 stars, and thus the point at which we would consider the stock an extremely attractive purchase. Conversely, consider selling is the price at which a stock would have a 1 star rating, at which point we'd consider the stock overvalued, with low expected returns relative to its risk.

Stewardship Grades

We evaluate the commitment to shareholders demonstrated by each firm's board and management team by assessing transparency, shareholder friendliness, incentives, and ownership. We aim to identify firms that provide investors with insufficient or potentially misleading financial information, seek to limit the power of minority shareholders, allow management to abuse its position, or which have management incentives that are not aligned with the interests of long-term shareholders. The grades are assigned on an absolute scale--not relative to peers--and can be interpreted as follows: A means "Excellent," B means "Good," C means "Fair," D means "Poor," and F means "Very Poor."