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Analysis of Computer Sciences Corp.'s Fourth Quarter Results

New Broom Sweeps Clean

New Executive Team Takes Charge and Charges against Earnings; Stock Down in After-hours

SCOTTSDALE, June 13 - Van Honeycutt, Computer Sciences Corp.'s outgoing chairman, may still be technically in or near his chair (till July 31), but his legacy is already getting eroded by the new executive team, led by Mike Laphen, the new CEO (click on right thumbnail). Laphen had served as the company's COO for the last three years prior to being appointed CEO in late May.

"A new broom sweeps clean," goes an old saw. The new CSC leaders have done just that. They wasted no time taking charge and charges against earnings while sweeping clean the company's boardroom.

Their post-earnings teleconference was market by an unusual candor, which included some "mea culpa" statements, such as this one:

"CSC discovered significant errors in its accounting for tax liabilities in fiscal years 2000 through 2006 and other insignificant errors. The most significant of these errors related to the tax accounting for the amortization of tax bases of assets contributed to a consolidated affiliate.

In addition, errors were identified in accounting for income tax liabilities related to foreign operations, as well as favorable adjustments in the preparation of U.S. federal tax returns.

http://djurdjevic.com/Bulletins2007/25_CSC_4Q.asp?
As a result of these changes, interest and penalties were accrued. The company also identified a correction required with respect to the accounting for the sale of licenses for a software product. The total effect of the errors resulted in a reduction of net income of $22.2 million and $90.7 million for fiscal years 2007 and 2006, respectively.

(An excerpt from CSC’s 4Q release, 6/13/07, delayed for several weeks pending investigations of the outgoing leaders’ transgressions)

For the full fiscal year 2007, that ended March 31, "special items" amounted to $316 million or $1.56 per share. That's not a small piece of change given that the company’s net income was $389 million, down from $471 million the year before. In the latest (fourth) quarter, the charges against earnings were $36 million or 14 cents per share.

**Stock Slips Despite Good Quarterly Results**

Wall Street generally likes charges, so it traded CSC shares up 2.4% to $56 in regular on rumors about a good quarter and write-offs. But then investors turned around and sold the stock off, down 2.8% to $54.5 in after-hours trading, after the fourth quarter facts were disclosed. So our old adage “up on rumors, down on facts” once again came true.

Nevertheless, CSC shares are now still at about the same level as a year ago, when the company tried and failed to sell itself off, and then resorted to stock buybacks as its "plan B" strategy (see above chart).

**Revenue Shortfall Sinks Shares**

And what was so disappointing about the fourth quarter facts? Actually, not much. We thought it was a pretty good quarter. Revenue was a little light relative to Wall Street expectations, but new contract sales by far exceeded them, thus implying solid revenues and profits in the future. While revenue rose to $4.05 billion from $3.89 billion, it missed slightly Wall Street’s average estimate of $4.1 billion.
"Our fourth quarter results continued to display our solid operational progress in a transition year," said Laphen, CSC's COO for the last three years, in a statement. And the future doesn't look too shabby, either.

The fourth quarter new bookings were $4.3 billion, bringing the full-year total to $16.9 billion, up about 40% from the last fiscal year. That's the highest level in the company's history. The annual total was split 55%/45% between federal and commercial awards.
"Our (record) bookings reflect improvements on the outsourcing side," he added, answering a question during a post-earning teleconference with analysts.

The company’s U.S. federal pipeline of opportunities over the next 22 months is approximately $44 billion, CSC said, up nearly 35% from the same time last year, and is comprised of more than 500 programs across a broad spectrum of government agencies and departments. Of the total pipeline, approximately $22 billion is scheduled for award in the current fiscal year.

Net income in the fourth quarter jumped to $249.7 million, or $1.42 per share, from $158.8 million, or 84 cents per share, a year earlier. But the fourth quarter commercial revenues fell 3% to $991 million.

For the full year, revenues were $14.9 billion, up 1.5% (down less than 0.5% in constant currency) over last year’s comparable 12-month period. This makes CSC the sixth largest IT services company in the world [not fifth (!), as the U.S.-focused media tend to report - see the right thumbnail for actual global rankings].

**Business Segment Analysis**

U.S. government sector revenues increased 5% to $1.43 billion in the fourth quarter, up from $1.37 billion in fiscal 2006. The Pentagon-related business was $978 million, up over 6% from the year-ago total, while revenues from civil agencies were $415.1 million, down slightly compared to last year.

Fourth quarter global commercial revenue was $2.61 billion, up 3.5% from $2.53 billion in the year-ago quarter, but down 2% in constant currency. Weakness in the domestic market was the main reason. U.S. commercial revenues were $991 million, down 3% from $1.02 billion last year. So momentum is clearly swinging again back to the government business (click on thumbnail chart).

European revenues were $1.23 billion, up 9% as reported, but down 1% in constant currency despite a boost from CSC’s takeover of the U.K. National Health Service megadeal from Accenture last year (see "Accenture’s Emphatic Year-end Accents," Sep 2006).

CSC’s non-European international revenue was $389 million, up 5.3% but up less than 0.5% in constant currency.

**Outlook**

For the first quarter, CSC projects revenue in the range of $3.7 billion to $3.8 billion, in line with analysts' current consensus estimate. The company expects earnings of 65 cents to 75 cents a share, excluding special items, vs. analysts' views of 76 cents.

For the full year, CSC forecast 6% to 7% growth in revenue, reaching $15.7 billion to $15.9 billion, slightly above analysts' current consensus estimate. The company pegged earnings between $4 and $4.20 a share, excluding restructuring expenses and one-time items. Analysts had projected $4.19 a share.
CSC also expects to double its staff in India to about 14,000 after completing the $1.3 billion acquisition of Covansys Corp. The company is planning to spend about $40 million in the current fiscal year on a five-point business improvement program. A part of it includes boosting its India operations.

**Happy bargain hunting!**

Bob Djurdjevic

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