Sharekhan
by BNP PARIBAS

HCL Technologies

Strong quarter, raised guidance

Sector: IT & ITES
Results Update

	Change
Reco: **Buy**	↔
CMP: **Rs. 599**	
Price Target: **Rs. 670**	↑

↑ Upgrade ↔ No change ↓ Downgrade

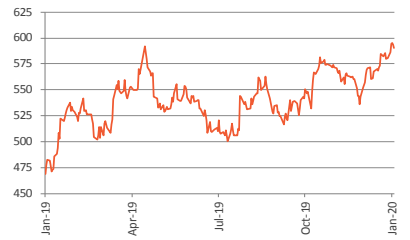
Company details

Market cap:	Rs. 162,494 cr
52-week high/low:	Rs. 601/466
NSE volume: (No of shares)	20.4 lakh
BSE code:	532281
NSE code:	HCLTECH
Sharekhan code:	HCLTECH
Free float: (No of shares)	54.3 cr

Shareholding (%)

Promoters	60.0
FII	28.4
DII	8.8
Others	2.8

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	7.4	8.0	16.8	27.4
Relative to Sensex	4.9	-0.7	8.5	9.1

Sharekhan Research, Bloomberg

HCL Technologies (HCL Tech) delivered a strong set of numbers, beating our estimates on all fronts. Revenue growth in constant currency (CC) term was 2.1% q-o-q and 16.4% y-o-y, led by 11.1% CC growth in Mode 3 and healthy growth in manufacturing, retail and communication verticals. EBIT margin improved 29BPS to 20.2% despite wage revision, exceeding our estimates, led by higher growth in software business and the exit of some non-strategic engagement (client at the tail end providing low margin). Net profit came at Rs 3,037 crores and was ahead of our estimated supported by higher other income and lower tax rate. The management raised FY2020E guidance for revenue growth to 16.5%-17.0% in CC (earlier 15-17%) and for EBIT margin to 19.0%-19.5% (earlier 18.5-19.5%). The revenue growth will be led by 6% inorganic growth (IBM IP deals, Strongbridge, Sankalp etc) and 10.5-11% organic growth. The management expects the growth momentum to continue in Q4FY2020E on the back of strong deal wins with increasing TCVs, accelerated pace of new customer additions and increasing share of wallets. The management also expects that the revenue addition in its product and platform business would accelerate in coming quarters and achieve its earlier target of $625 million in the first year of operation. Given the robust deal pipeline and higher number of transactions in HCL software business, we believe that healthy growth momentum would continue in FY2021E.

Key positives

- Raises FY2020E guidance for CC revenue growth to 16.5%-17.0% and EBIT margin to 19.0%-19.5%.
- Five out of seven verticals show strong double-digit growth

Key negatives

- Muted growth in Mode-1 and Mode-2 owing to tail cutting strategy
- Revenue from Technology and LifeSciences & Healthcare verticals was lower by 28.8% and 0.9% q-o-q respectively.

Our Call

Valuation – Maintain Buy with revised PT of Rs. 670: We have fine-tuned our earnings estimates for FY2020E/FY2021E, to factor in healthy nine month performance and upward revision in guidance by the management for FY2020. We have also introduced FY2022E estimates in this report. A strong deal pipeline along with large addressable opportunity in IMS provides the visibility of industry-leading organic revenue growth among large peers in FY2020E. At CMP, the stock trades at 14x/13x of its FY2021E/FY2022E earnings, which look attractive considering better revenue growth versus large peers over FY2019-FY2022E. We maintain our Buy rating on the stock with a revised PT of Rs. 670.

Key Risks

Any integration issues in ongoing M&A activities especially IP-related transactions could impact earnings. Further, high dependence on IMS could create challenges to its revenue growth trajectory.

Valuation — Rs cr

Particulars	FY18	FY19	FY20E	FY21E	FY22E
Revenue	50,570.0	60,427.0	70,952.0	78,819.8	86,262.7
OPM (%)	22.6	23.1	23.4	23.5	23.4
Adjusted PAT	8,780.0	10,123.0	10,919.0	11,953.4	12,957.7
% YoY growth	3.8	15.3	7.9	9.5	8.4
Adjusted EPS (Rs.)	31.3	36.8	40.2	44.1	47.8
P/E (x)	19.1	16.3	14.9	13.6	12.5
P/B (x)	2.3	2.1	1.7	1.5	1.4
EV/EBITDA (x)	7.0	5.7	4.8	4.3	3.9
RoNW (%)	25.3	26.0	24.8	24.1	23.3
RoCE (%)	30.0	29.2	27.2	27.2	26.7

Source: Company; Sharekhan estimates

Strong quarter: HCL Tech delivered strong set of results across financial parameters. Revenue growth in constant currency (CC) term was 2.1% q-o-q and 16.4% y-o-y, above our estimates. In reported terms, USD revenues were up by the 2.3% q-o-q and 15.5% y-o-y to $2,543 million. The strong revenue growth was led by 11.1% CC growth in Mode 3 and healthy growth in manufacturing, retail and communication. EBIT margin improved by 29BPS to 20.2%, led by i) outstanding performance in software business, ii) exit of some non strategic engagement (client at the tail end providing low margin) despite headwinds of annual pay hikes mitigated by enhanced productivity. Net profit increased by 14.6% q-o-q and 16.3% y-o-y to Rs 3,037 crores, led by higher other income and lower tax rate.

Growth in key business segment remains muted while in key geography declines: The revenue mix from business segment changed marginally as IT & Business services, Engineering and R&D services, Product & Platforms contributed 70.2%, 16.7 % and 13.1% as against 71.4%, 16.9% and 11.7% in Q2FY2020. The revenue in the three business verticals grew by 0.6%, 1.1% and 14.6% q-o-q respectively. In terms of geographical revenue mix, America, Europe and Rest of the World (RoW) contributed 62.8%, 29.2% and 8.0% respectively as against 67.9%, 25.7% and 6.4% in Q2FY2020. Revenue was lower by 5.4% q-o-q in America, while in Europe and RoW it grew by 16.3% and 27.9% q-o-q respectively. Higher furlough impacted the revenue growth momentum in America region as well as the two business verticals. Also, in order to enhance the margin profile to an extent the management consciously called off engagements with the clients (largely in mode 1 and some in mode 2) at the tail end wherein the overall company level margins were getting impacted.

Key result highlights from earnings call

- **Guidance revised upwards owing to strong performance:** Considering the performance of nine months coupled with healthy demand environment and strong traction in deal pipeline, the management raised FY2020E guidance for revenue growth to 16.5%-17.0% in constant currency (earlier 15-17%) and for operating (EBIT) margin to 19.0%-19.5% (earlier 18.5-19.5%). The revenue growth will be led by 6% inorganic growth (IBM IP deals, Strongbridge, Sankalp etc) and 10.5-11% organic growth. Also the USD revenue growth guidance has been raised to 15.2-15.7% (earlier 13.2-15.2% in Q2) for FY2020E.
- **Organic growth to remain healthy:** The management highlighted that the fourth quarter is expected to be a stronger quarter owing to strong deal wins with increasing TCVs, an accelerated pace of new customer additions and strong efforts in increasing the share from clients wallet. The company signed 12 transformational deals during Q3FY2020, led by key industry verticals such as Hi-Tech, Manufacturing and Financial Services.
- **Addition in most of the client buckets continues, client concentration reduces:** Two new clients each were added in the $100 million and $50 million client buckets taking the total count to 15 and 32 respectively sequentially. However, the client count reduced by four to 167 on sequential basis in the $10 million client bucket. The company has been making conscious efforts to reduce client concentration risk and hence the revenue contribution from Top 5/ Top 10 and Top 20 clients 15.2%/22.4% and 33.0% as against 16.5%/24.0% and 34.6% in Q2FY2020.
- **Moderation in hiring, pace of attrition lower:** The pace of hiring moderates, as the company had a gross addition of 11502, while net additions stood at 2050 during the quarter taking the total head count to 149,173. Attrition level has been slightly lower at 16.8% (declining trend since last 5 quarters).
- **Substantial increase in net cash balance, maintain dividend per share:** The net cash balance increased sustainably to $1.1 billion at the end of Q3FY2020 owing to strong performance and pickup in software business as compared to service business. This helped in improving the DSO days to 66 from 70 in Q2FY2020. The operating cashflow (OCF) stood at $ 709 million while the free cashflow (FCF) stood at $ 657 mn. This resulted in OCF/Net income conversion being at 109% and FCF/EBITDA being at 61% both on YTD basis. Considering the strong cash balance the Board maintained the Rs 2 dividend per share on the expanded equity base (Bonus Issue 1:1 in Q2FY2020)

Results					Rs cr
Particulars	**Q3FY20**	**Q3FY19**	**Q2FY20**	**y-o-y (%)**	**q-o-q (%)**
Revenue ($ mn)	**2,543.4**	**2,201.5**	**2,485.6**	**15.5**	**2.3**
Net sales	**18,135.0**	**15,699.0**	**17,528.0**	**15.5**	**3.5**
Direct costs	11,176.0	10,152.0	11,061.0	10.1	1.0
Gross profit	**6,959.0**	**5,547.0**	**6,467.0**	**25.5**	**7.6**
SG&A	2,155.0	1,900.0	2,039.0	13.4	5.7
EBITDA	**4,804.0**	**3,647.0**	**4,428.0**	**31.7**	**8.5**
Depreciation and amortisation	800.0	561.0	606.0	42.6	32.0
EBIT	**4,004.0**	**3,086.0**	**3,822.0**	**29.7**	**4.8**
Forex gain/(loss)	13.0	-54.0	-10.0	-124.1	-230.0
Other income	54.0	159.0	7.0	-66.0	671.4
PBT	**4,071.0**	**3,191.0**	**3,819.0**	**27.6**	**6.6**
Tax provision	692.0	566.0	835.0	22.3	-17.1
Net profit	**3,037.0**	**2,611.0**	**2,651.0**	**16.3**	**14.6**
EPS (Rs.)	11.2	9.6	9.8	16.4	14.6
Margin (%)				**BPS**	**BPS**
EBITDA	26.5	23.2	25.3	326	123
EBIT	22.1	19.7	21.8	242	27
NPM	16.7	16.6	15.1	11	162

Source: Company; Sharekhan Research

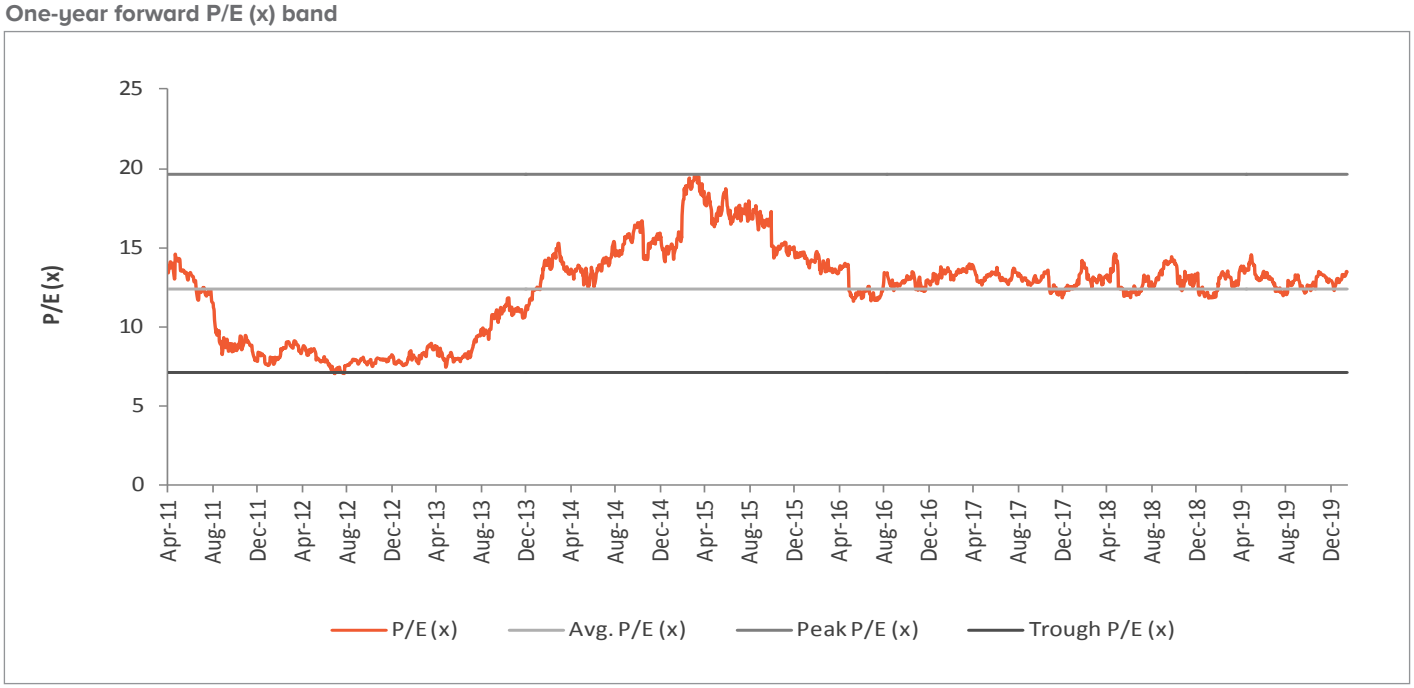
Outlook

Growth for Indian IT is expected to accelerate from current 6-7% as demand for digital services grows rapidly. India will continue to remain the preferred destination for talent supply and create a gradual shift of digital business from onsite. HCL Tech has invested aggressively in the fast-growing Mode-2 (a good proxy for digital offering) capabilities, which would help the company to match with the industry's growth. Further, the company has made large investments towards the acquisition of IP products to diversify its focus on new high-margin revenue streams. The addressable market opportunity for IMS is very large with only 10-12% penetration of addressable market. Given its differentiated positioning in IMS and strong capabilities in engineering services, HCL Tech is well positioned to maintain growth momentum in these segments going ahead.

Valuation

We have fine-tuned our earnings estimates for FY2020E/FY2021E, to factor in healthy nine month performance and upward revision in guidance by the management for FY2020. We have also introduced FY2022E estimates in this report. A strong deal pipeline along with large addressable opportunity in IMS provides the visibility of industry-leading organic revenue growth among large peers in FY2020E. At CMP, the stock trades at 14x/13x of its FY2021E/FY2022E earnings, which look attractive considering better revenue growth versus large peers over FY2019-FY2022E. We maintain our Buy rating on the stock with a revised PT of Rs. 670.

One-year forward P/E (x) band



Source: Sharekhan Research

About company

HCL Tech is a leading global technology company providing software-led IT solutions, remote infrastructure management, and BPO services and engineering-related services. Further, the company helps global enterprises re-imagine and transform their businesses through digital technology transformation. HCL Tech leverages its global network of integrated co-innovation labs and global delivery capabilities to provide holistic multi-service delivery in key industry verticals.

Investment theme

HCL Tech's revenue growth momentum is expected to accelerate, led by several large deal wins in the past few quarters and gradual recovery in infrastructure management services. The company focuses on chasing large deals to capture market share from incumbents in consolidation deals. Being the leader in IMS practices and the third-largest engineering services player globally in revenue, the company is well positioned to win large deal wins. Strong deal wins along with acquisition of select IP products will help the company to drive growth going ahead.

Key Risks

1) Continued slowdown in organic revenue growth, 2) integration issues in ongoing M&A activities, especially IP-related transactions, 3) rupee appreciation and/or adverse cross-currency movements, 4) pressure in renewal of IMS deals, 5) any hostile regulatory visa norms could have an impact on employee expenses, and 6) any major macro issues in developed markets, especially in the U.S. and Europe.

Additional Data

Key management personnel

Shiv Nadar	Founder & Chairman
C Vijay Kumar	President & CEO
Prateek Aggarwal	Chief Financial Officer
G H Rao	President – Engineering and R&D Services
Rahul Singh	President – Financial Services

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	BlackRock Inc	1.60
2	Artisan Partners LP	1.48
3	Vanguard Group Inc/The	1.44
4	SBI Funds Management Pvt Ltd	1.30
5	ICICI Prudential Asset Management	1.26
6	Life Insurance Corp of India	1.11
7	Vontobel Holding AG	0.96
8	Nomura Holdings Inc	0.87
9	Virtus Investment Partners Inc	0.85
10	Aditya Birla Sun Life Asset Manage	0.85

Source: Bloomberg

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