



3R MATRIX

	+	=	-
Right Sector (RS)	✓	■	■
Right Quality (RQ)	✓	■	■
Right Valuation (RV)	✓	■	■
	+ Positive	= Neutral	- Negative

What has changed in 3R MATRIX

	Old		New
RS	■	↔	■
RQ	■	↔	■
RV	■	↔	■

ESG Disclosure Score **NEW**

**ESG RISK RATING** **16.46**  
Updated Oct 08, 2021

**Low Risk**

NEGL	<b>LOW</b>	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

Company details

Market cap:	Rs. 3,02,112 cr
52-week high/low:	Rs. 1,377 / 815
NSE volume: (No of shares)	47.7 lakh
BSE code:	532281
NSE code:	HCLTECH
Free float: (No of shares)	107.6 cr

Shareholding (%)

Promoters	60.3
FII	22.8
DII	12.9
Others	3.9

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	(4.5)	(3.4)	19.4	32.7
Relative to Sensex	(0.7)	(8.2)	3.6	(0.4)

Sharekhan Research, Bloomberg

IT & ITES

Sharekhan code: HCLTECH

Reco/View: Buy

CMP: Rs. 1,113

Price Target: Rs. 1,400

Upgrade ↔ Maintain ↓ Downgrade

Summary

- We expect a strong bounceback in growth in Q3FY2022 given strong deal wins, robust net headcount addition, anticipated good recovery in products & platforms business, client additions and broad-based demand.
- HCL Tech's strong IMS capabilities, robust partnerships with hyperscalers and strengths in digital foundation and modern applications position the company to capitalise opportunities in cloud space.
- HCL Tech's new payout ratio of at least 75% of net income over FY2022-2026 is positive. It provides comfort on efficient capital allocation ahead and will limit any large inorganic investments.
- We maintain a Buy on HCL Technologies with a PT of Rs. 1,400, given strong growth momentum in services business, robust deal win TCVs, aggressive net headcount addition and reasonable valuation.

HCL Technologies' (HCL Tech's) greater focus towards digital foundation, leadership position in engineering and R&D services (ERS) business, and investments in modern applications to win fair share of integrated deals position the company to drive its strong growth momentum in its IT services business (around 88% of its total revenue). We expect a strong bounceback in growth during Q3FY2022 given its strong deal wins, robust net headcount addition, anticipated good recovery in products & platforms business, client additions and broad-based demand. We believe higher spends on cloud transformation initiatives by clients will create strong impetus for HCL Tech's IMS business given its competitive advantage among its peers and strong partnerships with hyperscalers.

- Cloud likely to be a growth driver for its IMS business:** Cloud is expected to create huge opportunity to Indian IT services companies beyond initial migration phase. It is estimated that around 20-30% of workloads have moved to cloud and this can increase to 70-80% over next 3-5 years. HCL Tech has invested in building capabilities around cloud native industry-specific solutions to help customers derive more value from their cloud investments. HCL Tech's strong IMS capability, strong partnerships with hyperscalers and strengths in digital foundation and modern applications position the company to capitalize opportunity in cloud space.
- Accelerated spends on digital engineering likely augur well for its ERS business:** HCL Tech has strong capabilities in engineering and R&D services (ERS) business given its investments in emerging areas like 5G, IIoT, data engineering and softwarization. The pandemic has accelerated investments in many digital engineering applications. As industry is moving towards digital engineering related programs, we believe HCL Tech is well positioned to garner a fair share of opportunity given its strong ER&D capabilities.
- Expect strong pickup in growth in Q3:** We expect a strong bounceback in growth in Q3FY2022 given its strong deal wins, robust net headcount addition, anticipated good recovery in products & platforms business, client additions and broad-based demand. The company recruited around 35,549 employees on a net basis in last four consecutive quarters, which increased 2x y-o-y over its revenue growth over the same period. Strong headcount addition and robust deal booking provide growth visibility in the coming quarters of FY2022.

Our Call

**Valuation – Maintain Buy with a PT of Rs. 1,400:** We believe the company's strong digital capabilities, new geography expansion, solid competencies to capture opportunities in cloud space, aggressive net employee additions and broad-based demand would help HCL Tech to accelerate its growth in FY2023 and minimize the gap in growth with large peers in subsequent years. HCL Tech is likely to sustain its margin performance on the back of revenue growth, pyramid management, higher offshoring and expansion into low-cost smaller cities. The stock price has corrected by ~18% from the peak over last three months due to revenue miss in Q2FY2022. At CMP, the stock trades at a reasonable valuation of 19x/17x its FY2023E/FY2024E earnings, at a sharp discount to large peers. HCL Tech's new payout ratio of at least 75% of net income over FY2022-2026 is positive as it is likely to abate investors' concerns relating to its capital allocation strategies toward large acquisitions. Hence, we maintain a Buy on the stock with an unchanged PT of Rs. 1,400.

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

Particulars	FY21	FY22E	FY23E	FY24E
Revenue	75,379.0	84,762.6	94,891.3	1,05,432.8
OPM (%)	26.6	24.0	24.1	24.2
Adjusted PAT	13,010.0	13,230.6	15,074.8	17,096.6
% YoY growth	17.6	1.7	13.9	13.4
Adjusted EPS (Rs.)	47.9	50.2	57.2	64.8
P/E (x)	23.2	22.2	19.5	17.2
P/B (x)	5.0	4.8	4.5	4.2
EV/EBITDA (x)	14.5	14.7	13.2	11.9
RoNW (%)	23.3	21.5	23.1	24.6
RoCE (%)	25.0	23.7	26.2	28.2

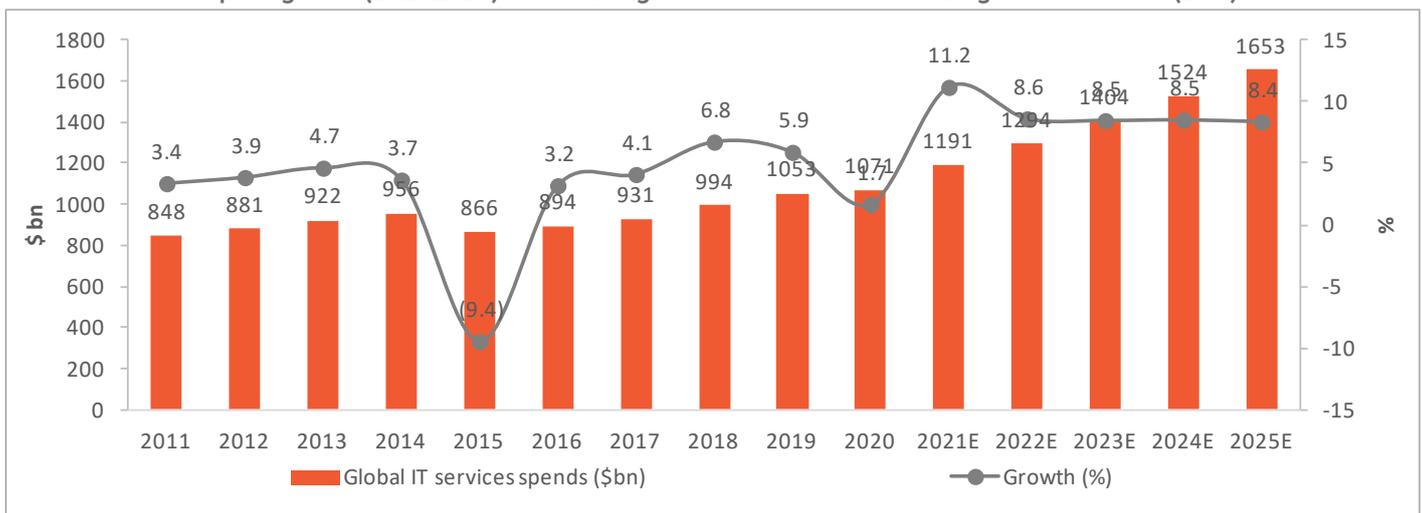
Source: Company; Sharekhan estimates

## Demand is expected to remain strong in the medium term

The pandemic has accelerated the pace of spending on digital technologies such as cloud, AI, machine learning, data and analytics, cybersecurity, collaboration tools, and engineering among others. Enterprises across the globe are now using these new-age technologies to enhance digital experience, reduce costs, increase efficiencies, and create greater operating resilience and agility within the organisation. Further, most of the large enterprises especially in Europe have been making a strategic shift towards outsourcing models for saving costs or increasing focus on core areas. Most large global companies are shifting technology investments from capex to opex as it would provide scalability. Technology spend is expected to increase to 5% of enterprise revenue over the next 5-10 years from 2-3% currently, as per McKinsey. Hence, we believe technology demand is expected to remain strong in the medium term, as investments on digital transformation initiatives are not limited to a short period of time.

According to the latest forecast, Gartner expects worldwide IT spending to rise by 9.5% y-o-y to \$4.2 trillion in 2021. Of this, Gartner forecasts IT services spend would grow by 11.2% in FY2021. Further, IT services spending is likely to remain strong at an 8.5% CAGR over FY2021-FY2025, which will be significantly higher than the average growth of 2.8% during the last decade.

### Global IT services spend growth (2021-2025) to remain higher than the levels seen during the last decade (2011)

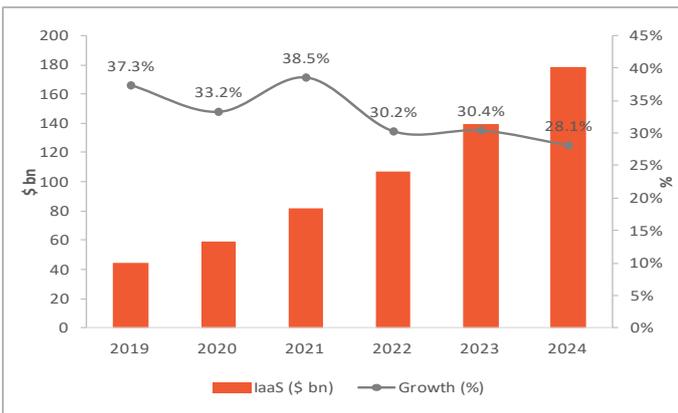


Source: Gartner, Sharekhan Research

## Stronger migration to cloud would create huge opportunities for Indian IT companies

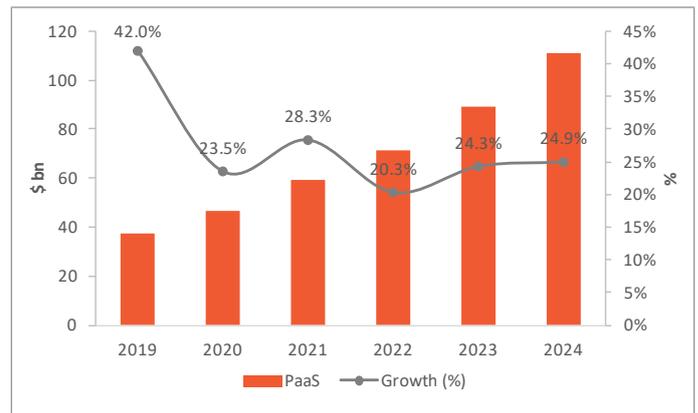
Cloud is expected to create a huge opportunity to Indian IT services companies beyond the initial migration phase. It is estimated that 20-30% of workloads have moved to cloud and this can increase to 70-80% over the next 3-5 years. Large global BFSI firms, which are the highest spender on technologies, are the laggards in cloud adoption among other industries, given the concerns over security and confidentiality. When a client will migrate to cloud, we believe that IT services spend would increase substantially as the client will participate in cloud-based ecosystems (including AI, data, and analytics spend) to derive benefits in terms of scalability, flexibility, resiliency, and agility. It is estimated that spending on public cloud services would grow at 28.5% over 2020-2024. As per Gartner, cloud penetration is expected to be the highest across cloud application software services (SaaS), followed by cloud application infrastructure software (PaaS), and cloud system infrastructure services (IaaS). Stronger migration to cloud will provide healthy impetus to demand for migration and transformation services to Indian IT services companies.

IaaS growth trend (%)



Source: Gartner, Sharekhan Research

PaaS growth trend (%)



Source: Gartner, Sharekhan Research

### Cloud likely to be a growth driver for its IMS business

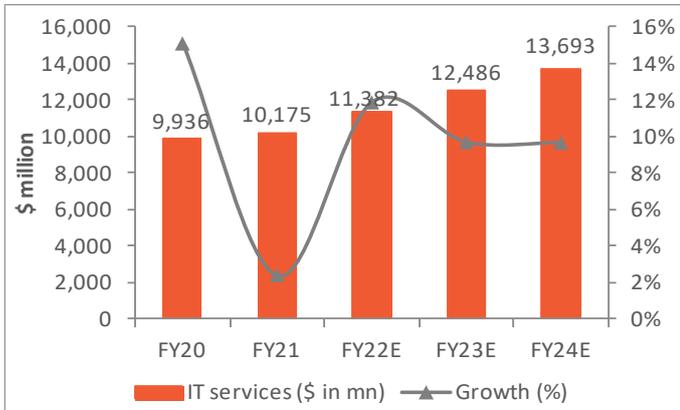
The strong demand environment is driven by higher spend on cloud transformation initiatives by global enterprises. As most clients are still in the early phase of cloud migration, we believe it will be a tailwind to HCL Tech’s IMS business given its leadership position among peers and strong partnerships with hyperscalers. Further, the company has invested in building capabilities around cloud native industry-specific solutions to help customers derive more value from cloud investments. The company has also invested meaningfully in its application capabilities apart from improving its position in digital transformation spending, given the strengths in digital foundation and modern applications. Further, management indicated that the company is one of the first large system integrators in the world to design a dedicated ecosystem business unit for each cloud hyperscaler. HCL Tech’s strong IMS capability, strong partnerships with hyperscalers, strengths in digital foundation, and modern applications position the company to capitalise opportunities in the cloud space.

### Expect strong recovery in growth in Q3 after underperformance

HCL Tech has been reporting lower-than-expected revenue growth for the past three consecutive quarters due to impact of second wave of COVID-19, change to insourcing of some parts of professional services contract, delays in new license sales in product business, and weak seasonality. We expect a strong bounce back of growth in Q3FY2022, given its strong deal wins, robust net headcount addition, anticipated good recovery in products and platforms business, client additions, and broad-based demand. The company continues to see strong demand for all its services, especially digital business, which includes application services, digital consulting, data analytics, and cloud services. The company has recruited around 35,549 employees on a net basis in the past four consecutive quarters, which increased 2x y-o-y over its revenue growth. Among tier-I IT companies, HCL Tech is the only company that reported growth on a sequential basis in its net new deal TCVs. The company has strong capabilities in ER&D services business and focuses on new emerging technologies such as 5G, IIoT, data engineering, and softwarisation to accelerate its growth in the ERS space. We believe HCL Tech’s investments around these four themes enable it to garner a fair share of opportunity as the industry is moving from project-based business to digital engineering-related projects. Strong deal wins, aggressive net employee additions, promising outlook in the services business, and continued investments in building capability and new geography expansion would help HCL Tech to accelerate its growth in FY2023 and minimise the gap in growth rate with large peers.

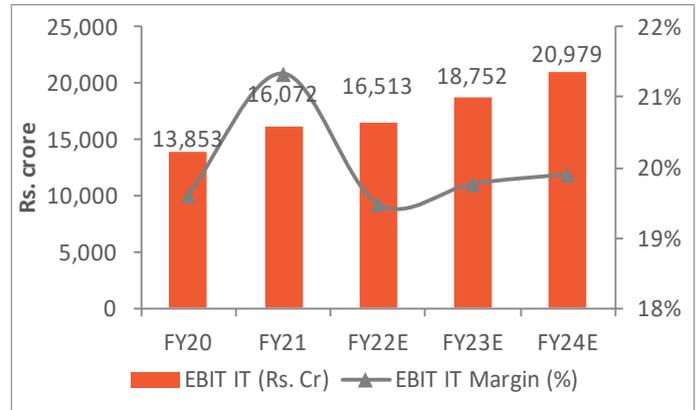
Financials in charts

Revenue in US\$ (mn) and growth (%)



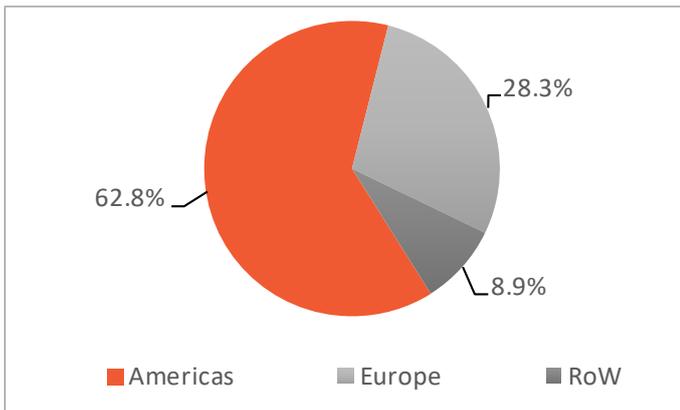
Source: Company, Sharekhan Research

EBIT (Rs. cr) and EBIT margin (%)



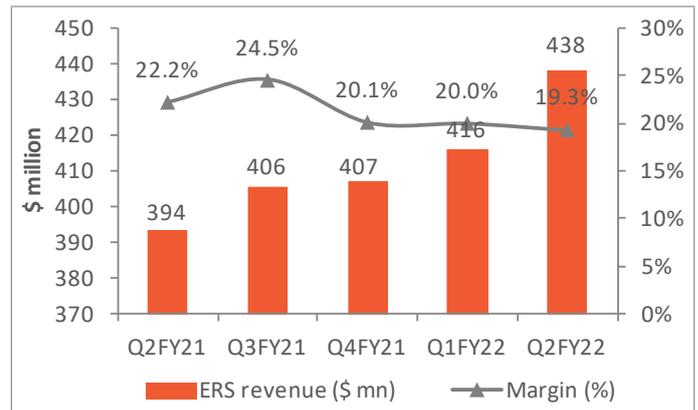
Source: Company, Sharekhan Research

Geography break-up (%)



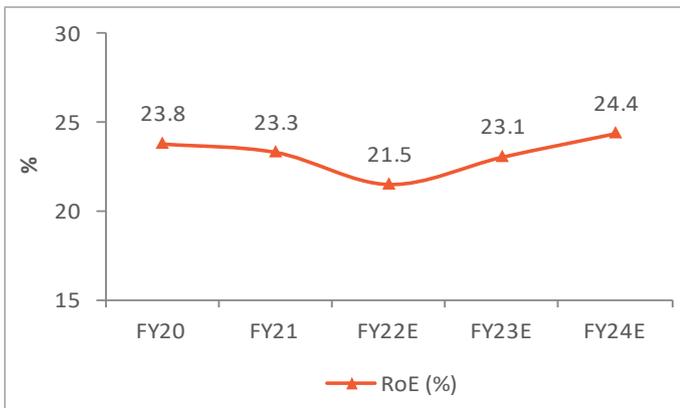
Source: Company, Sharekhan Research

ERS revenue (\$ mn) and margin (%)



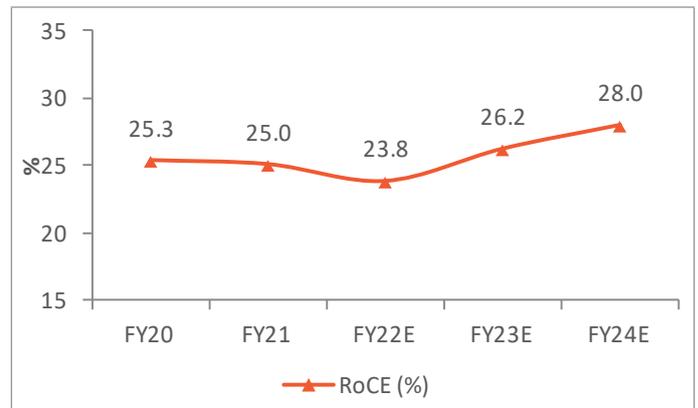
Source: Company, Sharekhan Research

RoE trend (%)



Source: Company, Sharekhan Research

RoCE trend (%)



Source: Company, Sharekhan Research

## Outlook and Valuation

### ■ Sector outlook – Expect acceleration in technology spending going forward

We believe the need for business continuity, operational resilience, and the switch to digital transactions have led to strong demand for IT services post the pandemic. Industry analysts such as Gartner estimate that IT services spending would grow by 8-8.5% in the next four years as compared to the average of 4.2% achieved over the past 10 years. Forecasts indicate higher demand for cloud infrastructure services, a potential increase in specialised software, potential investments in transformation projects by clients, and increased online adoption across verticals.

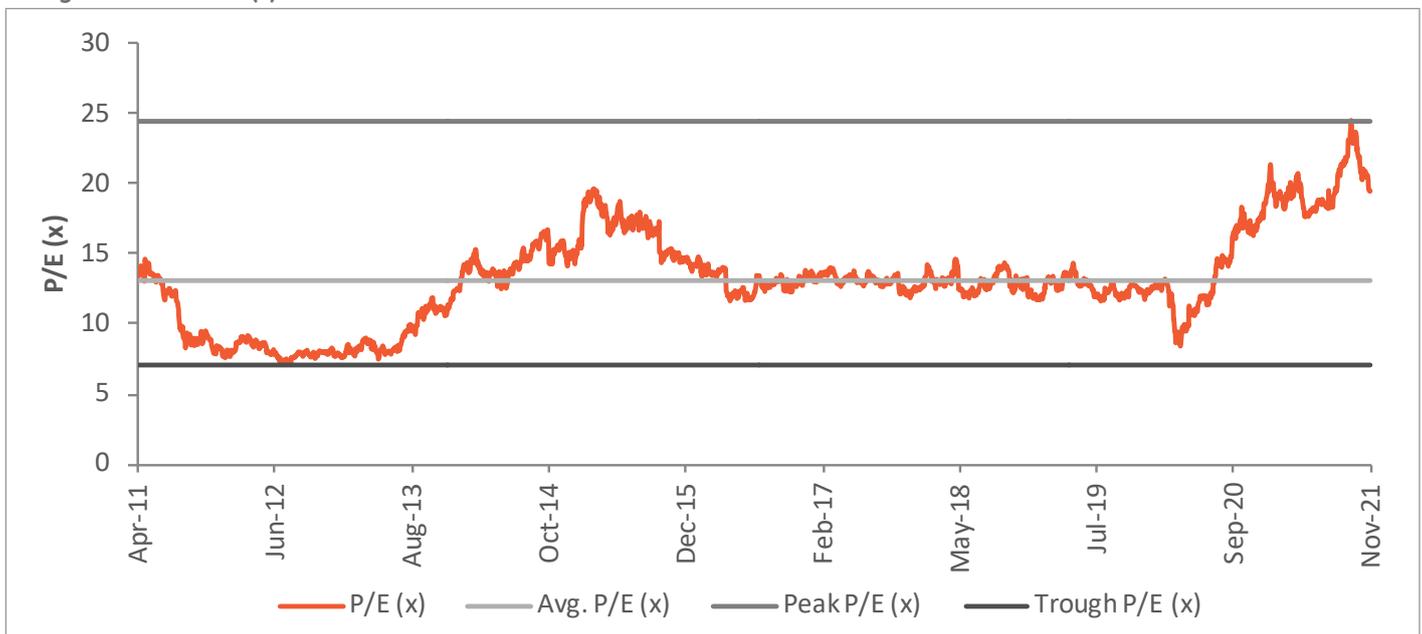
### ■ Company outlook – Growth on recovery path

HCL Tech has invested aggressively in the fast-growing Mode-2 (a good proxy for digital offering) capabilities, which would help HCL Tech to deliver strong revenue growth in the coming years. Given its differentiated position in IMS and strong capabilities in engineering services, HCL Tech is well positioned to maintain its growth momentum in the IT services business (88% of total revenue) going ahead. HCL Tech's strength in cloud infrastructure and capabilities in digital offerings make it a strong contender for building out digital foundations for clients.

### ■ Valuation – Maintain Buy with a PT of Rs. 1,400

We believe the company's strong digital capabilities, new geography expansion, solid competencies to capture opportunities in cloud space, aggressive net employee additions and broad-based demand would help HCL Tech to accelerate its growth in FY2023 and minimize the gap in growth with large peers in subsequent years. HCL Tech is likely to sustain its margin performance on the back of revenue growth, pyramid management, higher offshoring and expansion into low-cost smaller cities. The stock price has corrected by ~18% from the peak over last three months due to revenue miss in Q2FY2022. At CMP, the stock trades at a reasonable valuation of 19x/17x its FY2023E/FY2024E earnings, at a sharp discount to large peers. HCL Tech's new payout ratio of at least 75% of net income over FY2022-2026 is positive as it is likely to abate investors' concerns relating to its capital allocation strategies toward large acquisitions. Hence, we maintain a Buy on the stock with an unchanged PT of Rs. 1,400.

#### One-year forward P/E (x) band



Source: Company; Sharekhan Research

#### Peer valuation

Particulars	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)		EV/EBITDA (x)		P/BV (x)		RoE (%)	
				FY22E	FY23E	FY22E	FY23E	FY22E	FY23E	FY22E	FY23E
Infosys	1,732	421	7,28,500	32.6	27.6	22.4	19.5	4.9	4.5	27.6	30.2
TCS	3,464	370	12,81,240	32.7	28.5	23.2	20.2	14.4	14.0	44.5	49.9
Wipro	643	548	3,52,228	28.8	25.5	19.3	16.7	6.2	5.5	19.2	20.6
HCL Tech	1,113	271	3,02,112	22.1	19.5	14.7	13.2	4.8	4.5	21.5	23.1

Source: Company, Sharekhan estimates

## About company

HCL Tech is a leading global technology company providing software-led IT solutions, remote infrastructure management, 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 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 US and Europe.

## Additional Data

### Key management personnel

Shiv Nadar	Founder & Chairman
C Vijay Kumar	Managing Director & CEO
Prateek Aggarwal	Chief Financial Officer
Apparao V V	Chief Human Resources Officer
Kalyan Kumar	Chief Technology Officer and Head, Ecosystems

Source: Company Website

### Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	SBI Funds Management Pvt Ltd	2.4
2	Life Insurance Corp of India	2.3
3	Artisan Partners LP	1.8
4	ICICI Prudential Asset Management	1.8
5	BlackRock Inc	1.6
6	Vanguard Group Inc/The	1.3
7	Vontobel Holding AG	0.8
8	FMR LLC	0.7
9	Nomura Holdings Inc	0.7
10	Nippon Life India Asset Management Limited	0.6

Source: Bloomberg

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