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HCL Technologies Ltd.

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Poised for growth

HCL Technologies is engaged in providing a range of software, business process outsourcing and IT infrastructure services. The company has a wide geographical presence across 32 countries. It has a strong workforce of more than 104,000 employees.

Investment Rationale

Well poised to exploit the growth opportunity: NASSCOM estimates SMAC (social, mobility, analytics and cloud) revenues to account for c.20% of the total revenue of Indian IT companies in 2020, from current levels of ~5%. Internet of Things (IoT) connected devices are expected to increase to 6.4 bn and 20.8 bn by 2016 and 2020 respectively. The IoT spending is expected to witness 22% growth in 2016 to reach USD235 bn. Importantly, HCL Tech has made huge investments in Beyond Digital and IoT space over the last couple of quarters. We expect the company to make further investment to capture the huge growth opportunity in this space and that gives us confidence of continued traction in large deal wins going ahead.

Focus on digitalization to provide scale: In an environment where severe competition and pricing pressure in traditional IT services are eating away the margins of the software service providers, the company has made a strategic shift towards digital technologies and automation in the traditionally manual areas of business. HCL Tech has created differentiation by focusing on Beyond Digital, Next–Gen ITO and IoT WoRKS initiatives. The higher adoption of digital technologies will enhance its pricing power and will also provide scalability to its business.

Uptick in deal wins; key to growth: HCL Tech is witnessing traction in large deals, which is clearly visible from its 25 transformational deal wins in 9MFY16 with TCV of more than USD 4 bn. Besides, HCL Tech's leadership position in the Infrastructure management services (IMS) space and its continued deal wins in the rebid market reinforces our confidence of further deal wins from this space (TCV worth ~USD 146 bn expected over the next three years; IMS to account for 55% of the total rebid opportunity).

Acquisition of Geometric strengthens its engineering services capabilities: Engineering and R&D Services (ER&D) services remains the key focus area of HCL Tech (contributing 19% to total revenue). The acquisition of Geometric will further enhance its capabilities primarily in the product lifecycle management (PLM) consulting as well as in mechanical and manufacturing engineering. The deal brings in various synergy benefits and provides HCL Tech access to Geometric's 60 global clients in US and Europe. It would enable the company to cross sell its ER&D expertise to Geometric's clients.

Valuation: Sustained momentum in large deal coupled with its competence in the IMS and ER&D space, will aid growth and provides scalability to its business. We expect revenue and Adj. PAT to grow at a CAGR of ~31% and ~22% over FY16-18E. We initiate coverage on the stock with a BUY rating with a target price of Rs. 828 (based on FY18E P/E of 14x), implies a potential upside of ~15% over the next 1 year.

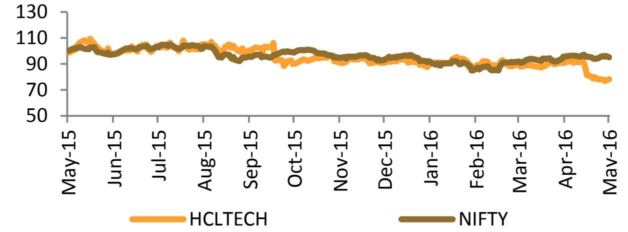
Market Data

Market Data	
Rating	**BUY**
CMP (Rs.)	723
Target (Rs.)	**828**
Potential Upside	15%
Duration	Long Term
Face Value (Rs.)	2
52 week H/L (Rs.)	1,044.9/706.4
Adj. all time High (Rs.)	1,058
Decline from 52WH (%)	30.8
Rise from 52WL (%)	2.3
Beta	0.8
Mkt. Cap (Rs.Cr)	101,972

Fiscal Year Ended

Y/E	FY15	FY16	FY17E	FY18E
Revenue (Rs.Cr)	36,701	30,781	46,046	52,500
Adj. Net profit (Rs.Cr)	7,317	5,643	7,526	8,343
Adj. EPS (Rs.)	52.0	40.0	53.4	59.2
Adj. P/E (x)	13.9	18.1	13.5	12.2
P/BV (x)	4.2	3.7	3.2	2.7
ROE (%)	33.4	21.9	25.4	24.1

One year Price Chart

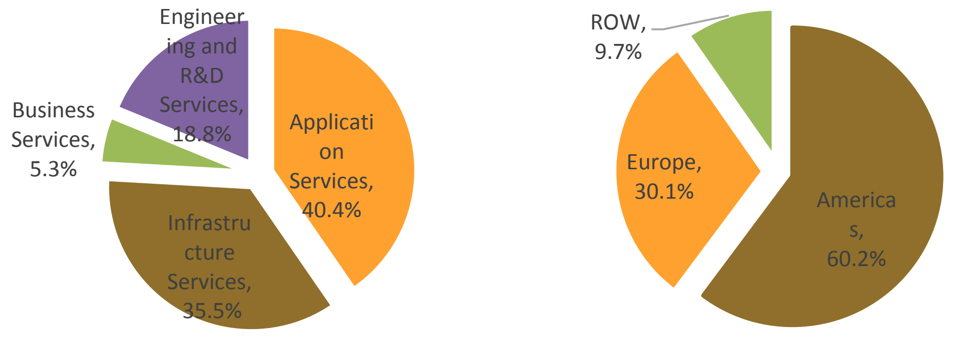


Shareholding Pattern	Mar-16	Dec-15	Chg.
Promoters (%)	60.4	60.4	0.0
Public (%)	39.6	39.6	0.0
Others (%)	-	-	-

HCL Technologies Ltd: Business overview

Incorporated in 1991, HCL Technologies is engaged in providing a range of software, business process outsourcing and IT infrastructure services. The company provides technology service across various verticals including financial services, manufacturing (automotive, aerospace, hi-tech and semiconductors), telecom, retail and consumer packaged goods services. Geographically, the company has diverse presence across 32 countries including Americas, Europe, Asia Pacific, Middle East and Africa. Its global strategic alliances have some reputed names that includes Microsoft, Cisco, SAP, HP, etc. It has a strong workforce of more than 104,000 employees.

HCL tech's service mix **Geographic mix**



Source: Company, In-house research

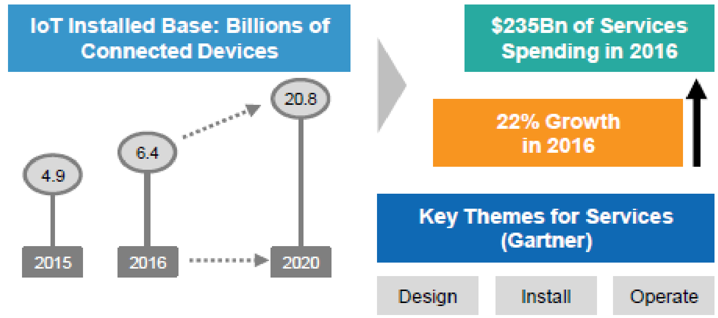
Well placed to ride on strong growth opportunities in IT industry

IOT connected devices is expected to increase to 6.4 bn in 2016 and to 20.8 bn by 2020.

NASSCOM estimates SMAC (social, mobility, analytics and cloud) revenues to account for c.20% of the total revenue of Indian IT companies in 2020, from current levels of ~5%. IoT connected devices is expected to increase to 6.4 bn in 2016 and to 20.8 bn by 2020 with the IoT spending to witness 22% growth in 2016 to reach USD235 bn. HCL has made strong inroads into the digital space through its deep focus on the Next-Gen ITO (Next Generation Information Technology Outsourcing), IoT (Internet of things) and digital. Beyond Digital was launched in 2015 and provides digitalization services to its customers. Further, the company has established a dedicated Business Unit, IoT WoRKS, in an endeavor to become the most valued IoT service provider globally by providing end–to–end offerings for organizations across different IoT adoption levels. All these initiatives are bearing fruits as the company is already witnessing traction with 30% of the new deals are coming from discrete offerings around Digitalization and IoT.

HCL Tech has made huge investments made in Beyond Digital and IoT space over the last couple of quarters and we expect the company to make further investment to capture the huge growth opportunity in this space, lends confidence of further traction in large deal wins going ahead.

IoT: 6.4 bn connected devices in 2016 leading to USD 235 bn services spending

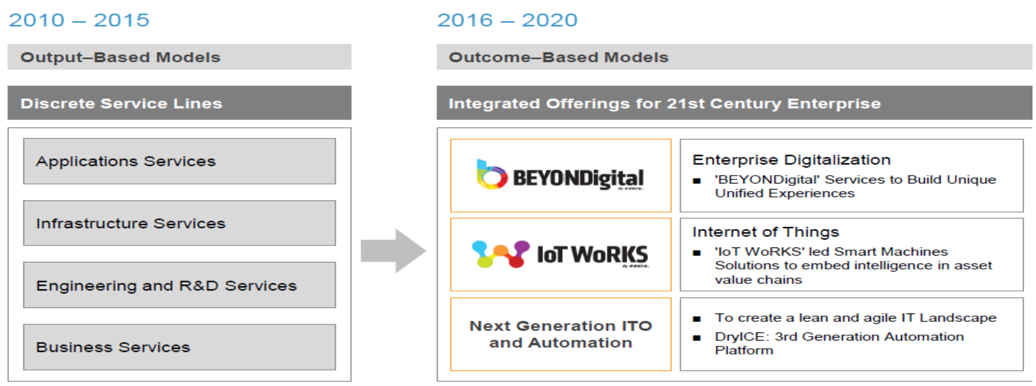


Source: Company

Focus on digitalization to provide scale

In an environment where severe competition and pricing pressure in traditional IT services are eating away the margins of the software service providers, HCL Tech has made a strategic shift towards digital technologies and automation in the traditionally manual areas of business. HCL Tech has created differentiation by focusing on Beyond Digital, Next–Gen ITO and IoT WoRKS initiatives. The higher adoption of digital technologies will enhance its pricing power and will also provide scalability to its business.

HCL's differentiated play for the 21st century



Source: Company

IMS – the backbone

HCL Tech continues to witness healthy deal wins in the infrastructure space and we expect the trend to sustain going ahead driven by increasing demand of next-gen infrastructure solutions and gaining traction in Gen 2.0 outsourcing deals.

Infrastructure management services (IMS) contributes ~35% to overall revenue and has grown at a CAGR of more than 30% over FY10-16. The company continues to witness healthy deal wins in the infrastructure space and we expect the trend to sustain going ahead driven by increasing demand of next-gen infrastructure solutions and gaining traction in Gen 2.0 outsourcing deals. In order to further strengthen its position in the IMS business, the company has recently launched a third generation automation framework – DryICE (combines artificial intelligence, machine learning, Automation, Orchestration and Knowledge Management).

Further, the company has launched a software-defined infrastructure solution center which will enable its clients to experience next-gen infrastructure solutions and technologies. With increasing adoption of hybrid cloud, the company continues to work very closely with a number of partners to retain business. Given its leadership position in the infrastructure space, we believe HCL Tech is well positioned to benefit from the rebid opportunity worth ~USD 146 bn (TCV) over the next three years (IMS to account for 55% of the total rebid opportunity). This lends strong long term growth visibility.

Traction in ER&D space augurs well

The company continues to witness good pipeline in Engineering Services driven by both internet of things as well as digital engineering.

HCL Tech has gradually enhanced its focus on Engineering and R&D Services (ER&D) and has created a dominance in this space (~19% of HCL Tech's revenue). The revenue contribution from this business exceeded USD 1bn milestone. Further, the company continues to witness good pipeline in Engineering Services driven by both internet of things as well as digital engineering. The increasing demand from first time outsourcers is also driving growth. The company is further strengthening its presence in this space by remaining a differentiator by building intellectual properties. The company's rich expertise is clearly reflected from its current involvement with more than 50% of the top 100 global R&D companies. We believe the growth in the engineering services space will be majorly driven by IoT and loacalisation initiatives. In order to strengthen its presence in IoT space, HCL Tech has made huge investments to provide end-to-end offerings to its clients. The company is also scaling up its presence in Engineering Services both in China and Mexico as clients prefer engineering services outsourcing to be closer to the manufacturing base.

We believe the company will stand to gain from the increase in engineering services outsourcing given its focused investment in this space. This also lends confidence on the future deal wins.

....Geometric's acquisition will further strengthen its engineering service capability

Geometric's acquisition will further enhance its capabilities primarily in the PLM consulting as well as mechanical and manufacturing engineering.

In a bid to further strengthen its presence in the ER&D space, the company has recently acquired Geometric Ltd (India's leading services provider of PLM consulting, mechanical engineering and manufacturing engineering) in all stock deal. HCLT would issue 10 equity shares of Rs. 2 each to Geometric shareholders for every 43 equity shares of Geometric held by them. The deal will add ~2% to HCL Tech's overall revenues and will also help company onboard close to 2,606 Geometric employees across 13 global delivery locations in the US, France, Germany, Romania, India and China. Geometric garnered revenues of Rs. 673.5 Crores in 9MFY16 and Rs 813.9 Crores in FY15. This acquisition excludes Geometric's 58% stake in 3DPLM Software Solutions, a JV with Dassault Systems.

This acquisition will further enhance its capabilities primarily in the PLM consulting as well as mechanical and manufacturing engineering. Given, HCL Tech's leadership position in this domain, the deal will bring in various synergistic benefits. It will get access to Geometric's 60 global clients in US and Europe primarily in the automotive and industrial engineering segments. HCL Tech will also acquire several unique IPs in PLM and digital manufacturing space and would enable the company to cross sell its ER&D expertise to Geometric's clients. Geometric's financial integration is expected by the end of this year. Hence, currently we are not building it in our revenue estimates.

Traditional verticals performance

HCL Tech's traditional verticals – Manufacturing and Financial Services (accounts for more than 50% of overall revenue) has grown at a modest pace in FY16 (LTM basis) (constant currency growth of ~9% and ~7% respectively). Though the traditional verticals continue to reel under pricing pressure, the shift in spend from traditional services to newer technologies is expected to provide some respite. The management expects further growth opportunity in this vertical on the back of momentum across its client base and opportunity from vendor consolidation.

The deal signing has remained healthy as it has bagged 25 transformational deals with TCV of more than USD 4 bn in 9MFY16.

The acquisition of Volvo's external IT business will help HCL Tech in strengthening its capabilities in mainframe and automotive domain.

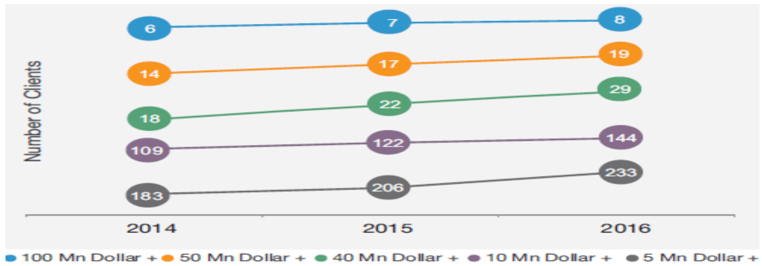
As regards manufacturing (largest revenue contributor ~32%), HCL Tech has prowess in automotive, aerospace, hi-tech and semi-conductors segment. With increasing engineering services opportunity in manufacturing space, we expect the company is well placed (given its competence) to drive growth. Financial Services on the other hand is the second largest revenue contributor (26%). The company continues to witness deal wins in this space on the back of growing vendor consolidation and adoption of digital technologies.

The management has highlighted that the emergence of Fintech and shift focus from Gen 1 to Gen 2/3 outsourcing is creating demand for IT simplification, automation and artificial intelligence. The clients looking for Gen 2/3 outsourcing is resulting in vendor consolidation to drive efficiency. As a result, this creates opportunity for HCL Tech to target large deals in this space. Further, the emergence of Fintech in the financial services business is driving investments in customer experience, digital and cloud. The company's strategy to make huge investments in Beyond Digital space augurs well for the company.

Uptick in deal wins; a key growth trigger

HCL Tech is witnessing traction in large deal, which is clearly visible as it has bagged 25 transformational deals with TCV of more than USD 4 bn in 9MFY16 as against 58 transformational engagements signed in FY15 with USD 5bn+ TCV. The deal signing has remained healthy driven by Next-gen ITO, Engineering Services Outsourcing, Digital, etc. We expect the growth will be further driven by traction in large deal coupled with ramp up of existing deals bagged over the last few quarters. We expect the revenue to pick up as the company starts delivering these deals. The client addition also remains robust with the company adding 1 new client in USD 100 mn+, 2 new clients in USD 50 mn+ bracket, 7 new clients in USD 40 mn+ bracket and 22 new clients in USD 10 mn+ bracket in 9MFY16.

Client mix



Source: Company

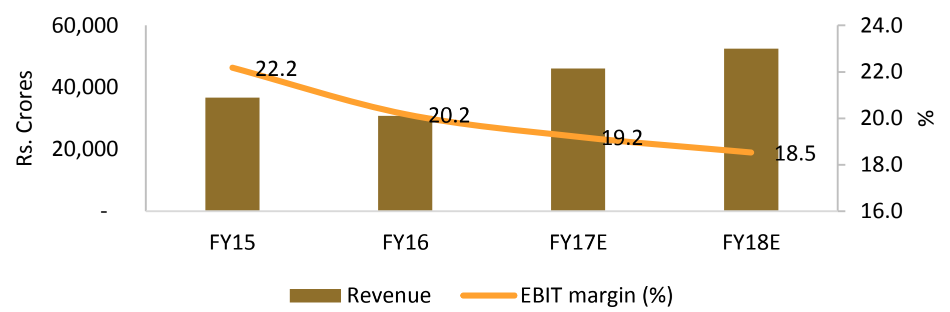
Volvo deal

HCL Tech has acquired Volvo's external IT business and also signed a significant five-year IT outsourcing deal with the Volvo Group (one of the world's leading manufacturers of commercial vehicles). With the acquisition of Volvo's external IT business, HCL Tech will add 40 new customers from Nordics and France, further enhancing its market leadership position in these regions. It will also help the company in strengthening its capabilities in mainframe and automotive domain. The acquisition will result in addition of approximately 2,500 people working for the Volvo Group across 11 countries to HCL. This will also enable HCL to create an automotive Centre of Excellence in Gothenburg, based on the domain expertise of the Volvo team, to serve HCL's global automotive and manufacturing customers. As part of the IT outsourcing deal with Volvo, HCL Tech will undertake Volvo's infrastructure and operation services. Volvo's financial integration is expected in Q1FY17. Hence, currently we are not building it in our revenue estimates.

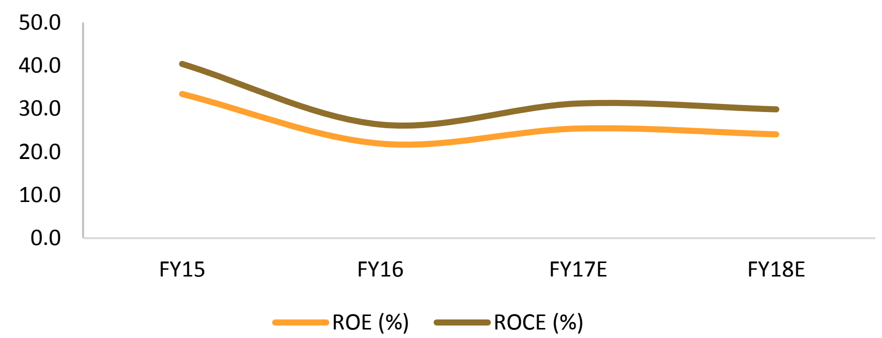
Revenue & Adj. PAT to grow at a CAGR of ~31% and ~22% respectively over FY16-18E

We expect HCL Tech's revenue to grow at ~31% CAGR over FY16-18E on the back of its robust order book position. The rebid market opportunity in the IMS space and continued deal wins bolsters our confidence on the revenue visibility of the company. As the company have dominance in IMS and ER&D space, it would provide traction and scalability to its business. However, we expect the margins to moderate over the next two years mainly on account of investments mostly towards building capability in digital and engineering services. We expect EBIT margin to ease to 18.5% in FY18E from 20.2% in FY16. The net profit is projected to grow at a CAGR of ~22% over FY16-18E. ROE & ROCE are likely to improve to 24.1% and 29.9% in FY18E, respectively. At CMP, the stock trades at a PE of 13.5x/12.2x for FY17E/FY18E. We believe most of the negatives are already priced in the stock. Hence, we recommend 'Buy' rating with a target PE of 14x, which is at a discount to the past three-year avg of 1 yr fwd PE (15.9x).

Revenue to grow at ~31% CAGR over FY16-18E



Return ratios trend



Source: Company, In-house research

Key risks:

- Appreciation of INR against USD.
- Slowdown in global IT spend.
- Higher-than-expected decline in margin.

Profit & Loss Account (Consolidated)

Y/E (Rs.Cr)	FY15	FY16	FY17E	FY18E
Total operating Income	36,701	30,781	46,046	52,500
Raw Material cost	1,271	704	3,223	3,675
Employee cost	17,726	15,093	23,391	27,038
Other operating expenses	9,158	8,378	9,983	11,382
EBITDA	**8,546**	**6,606**	**9,449**	**10,405**
Depreciation	404	393	604	676
EBIT	8,142	6,213	8,845	9,730
Interest cost	91	74	110	110
Other Income	1,066	830	803	1,023
Profit before tax	9,117	6,969	9,537	10,643
Tax	1,815	1,364	2,051	2,341
Profit after tax	7,302	5,605	7,487	8,301
Minority Interests	25	18	19	20
P/L from Associates	40	56	59	62
Reported PAT	**7,317**	**5,643**	**7,526**	**8,343**
E/o income / (Expense)	-	-	-	-
Adjusted PAT	**7,317**	**5,643**	**7,526**	**8,343**

Balance Sheet (Consolidated)

Y/E (Rs.Cr)	FY15	FY16	FY17E	FY18E
Paid up capital	281	282	282	282
Reserves and Surplus	23,943	27,012	31,661	37,127
Net worth	**24,224**	**27,294**	**31,943**	**37,409**
Minority Interest	82	312	331	351
Total Debt	648	952	999	999
Other non-current liabilities	825	841	883	927
Total liabilities	**25,779**	**29,398**	**34,157**	**39,687**
Net fixed assets	3,482	5,185	6,081	6,705
Capital WIP	552	500	500	500
Goodwill	4,793	4,877	4,877	4,877
Investments	869	855	855	855
Total Net Current Assets	12,819	14,380	17,965	22,718
-Net CA	3,033	5,095	4,101	4,300
-Cash	9,786	9,285	13,864	18,419
Deferred tax assets (Net)	790	826	826	826
Other non-current assets	2,475	2,776	3,053	3,206
Total Assets	**25,779**	**29,398**	**34,157**	**39,687**

Cash Flow Statement (Consolidated)

Y/E (Rs.Cr)	FY15	FY16	FY17E	FY18E
Pre tax profit	9,117	7,025	9,596	10,705
Depreciation	404	393	604	676
Chg in Working Capital	(1,188)	(2,384)	759	(307)
Others	(1,019)	(756)	(693)	(913)
Tax paid	(1,774)	(1,364)	(2,051)	(2,341)
Cash flow from operating activities	**5,539**	**2,914**	**8,216**	**7,819**
Capital expenditure	(1,208)	(2,044)	(1,500)	(1,300)
Chg in investments	(70)	14	-	-
Other investing cashflow	(809)	830	803	1,023
Cash flow from investing activities	**(2,088)**	**(1,200)**	**(697)**	**(277)**
Equity raised/(repaid)	10	1	-	-
Debt raised/(repaid)	(301)	304	48	-
Dividend paid	(2,385)	(2,877)	(2,877)	(2,877)
Other financing activities	(464)	(74)	(110)	(110)
Cash flow from financing activities	**(3,140)**	**(2,646)**	**(2,940)**	**(2,987)**
Net chg in cash	311	(932)	4,579	4,554

Note: FY16 is a 9 month period due to change in accounting year to March from June
We have not factor in the Geometric acquisition and Volvo acquisition in our estimates yet.

Key Ratios (Consolidated)

Y/E	FY15	FY16	FY17E	FY18E
Valuation(x)				
P/E	13.9	18.1	13.5	12.2
EV/EBITDA	10.8	14.2	9.5	8.2
EV/Net Sales	2.5	3.1	1.9	1.6
P/B	4.2	3.7	3.2	2.7
Per share data				
EPS	52.0	40.0	53.4	59.2
DPS	17.0	17.0	17.0	17.0
BVPS	172.3	193.5	226.5	265.2
Growth (%)				
Net Sales	14.2	(16.1)	49.6	14.0
EBITDA	6.4	(22.7)	43.0	10.1
Net profit	16.4	(22.9)	33.4	10.8
Operating Ratios				
EBITDA Margin (%)	23.3	21.5	20.5	19.8
EBIT Margin (%)	22.2	20.2	19.2	18.5
PAT Margin (%)	19.9	18.3	16.3	15.9
Return Ratios (%)				
RoE	33.4	21.9	25.4	24.1
RoCE	40.4	26.3	31.2	29.9
Turnover Ratios (x)				
Sales/Total Assets	1.1	0.8	1.1	1.1
Sales/Working Capital	16.2	7.6	10.0	12.5
Liquidity and Solvency Ratios (x)				
Current Ratio	2.4	2.4	2.6	2.7
Interest Coverage Ratio	89.3	84.2	80.5	88.5
Debt/Equity	0.0	0.0	0.0	0.0

Rating criteria

Large Cap.	Return	Mid/Small Cap.	Return
Buy	More than equal to 10%	**Buy**	More than equal to 15%
Hold	Upside or downside is less than 10%	**Accumulate***	Upside between 10% & 15%
Reduce	Less than equal to -10%	**Hold**	Between 0% & 10%
		Reduce/sell	Less than 0%

* To satisfy regulatory requirements, we attribute 'Accumulate' as Buy and 'Reduce' as Sell.

* HCL Tech is a large cap company

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