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# HCL Technologies Ltd.

May 18, 2018

**BSE Code: 532281** | **NSE Code: HCLTCEH** | **Reuters Code: HCLT:NS** | **Bloomberg Code: HCLT:IN**

**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 120,000 employees.**

## Investment Rationale

- **Healthy revenue growth:** HCL reported better than expected numbers in Q4FY18 with consolidated revenue increasing by 2.5% QoQ in USD terms. While, in CC terms, revenue growth stood at 1.2% QoQ. The growth was driven by IMS business (accounts for ~37% of revenue), which witnessed heathy growth of 2.5% QoQ in CC terms followed by E&RD (1.7%) and BPO services (5.3%) that helped to offset weakness in application services (down by 0.9% QoQ). Vertically the growth was broad based mainly led by financial services (2%), public services (4.1%) and telecommunications, media, publishing & entertainment (1.8%).

- **Margin to come under pressure in FY20:** In line with healthy revenue growth coupled with lower outsourcing cost, EBIT margin expanded by 127bps QoQ to 19.7% in Q4FY18. Importantly, management has maintained EBIT margin guidance of 19.5-20.5% for FY19E. Although we factor EBIT margin at the lower end of management guided range of 19.1% in FY19E, we factor 50bps decline in EBIT margin in FY20E owing to higher inorganic investments.

- **Revenue to grow at 11% CAGR over FY18-20E:** Importantly, management has provided revenue growth guidance of 9.5-11.5% in CC terms for FY19 translating to 10.5%-12.5% in USD terms. This includes inorganic revenue contribution from recent acquisitions (C3i Solutions and Actian Corp) and implies equal contribution from both organic and inorganic businesses. Management believes incremental contribution from recent acquisitions would largely be offset by weakness in India business, pressure in renewals in its legacy business (due to automation & cloud migration) and contracting deal sizes in FY19. However, it is optimistic of revival in IMS business in H1FY19 driven by recent deal closures. We believe the management's tepid organic revenue growth guidance is disappointing given expected turnaround in the IMS business. We factor revenue CAGR of 11% over FY18-20E owing to healthy deal pipeline, traction in digital business and expected turnaround in IMS business.

**Valuations:**

Despite factoring 11% revenue CAGR over FY18-20E, PAT is expected to grow at modest CAGR of 6% over FY18-20E owing to higher amortisation cost and tax rate. We maintain 'BUY' rating on the stock with revised TP of Rs. 993 based on 14xFY20E.

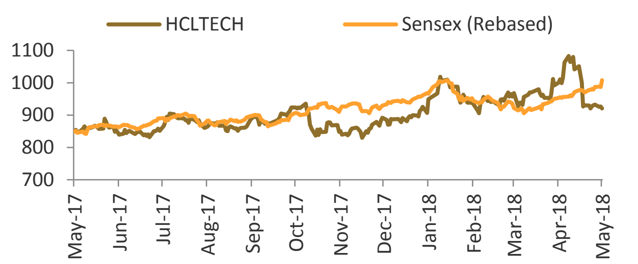
**Market Data**

| | |
|---|---|
| **Rating** | **BUY** |
| **CMP (Rs.)** | 890 |
| **Target (Rs.)** | 993 |
| **Potential Upside** | 12% |
| **Duration** | Long Term |
| Face Value (Rs.) | 2.0 |
| 52 week H/L (Rs.) | 1,107/825 |
| Adj. all time High (Rs.) | 1,107 |
| Decline from 52WH (%) | 19.6 |
| Rise from 52WL (%) | 7.9 |
| Beta | 0.5 |
| Mkt. Cap (Rs.Cr) | 123,857 |

**Fiscal Year Ended**

| Y/E | FY17 | FY18 | FY19E | FY20E |
|---|---|---|---|---|
| Net sales (Rs.Cr) | 47,568 | 50,569 | 56,774 | 62,158 |
| Net profit (Rs.Cr) | 8,606 | 8,721 | 9,218 | 9,867 |
| EPS (Rs.) | 60.3 | 62.7 | 66.2 | 70.9 |
| P/E (x) | 14.8 | 14.2 | 13.4 | 12.6 |
| P/BV (x) | 3.9 | 3.4 | 3.1 | 2.8 |
| ROE (%) | 28.5 | 25.2 | 23.9 | 23.1 |

**One year Price Chart**

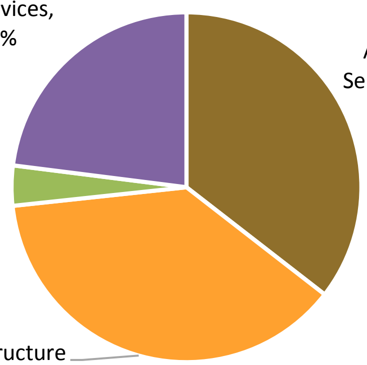



| Shareholding Pattern | Mar-18 | Dec-17 | Chg. |
|---|---|---|---|
| Promoters (%) | 60.2 | 60.2 | - |
| Public (%) | 39.8 | 39.8 | - |

## 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, 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. It has a strong workforce of more than 120,000 employees. It offers an integrated portfolio of products, solutions, services, and IP through its Mode 1-2-3 strategy built around Digital, IoT, Cloud, Automation, Cybersecurity, Analytics, Infrastructure Management and Engineering Services, amongst others.

**HCL Tech's service mix**




*Source: Company, In-house research*

**Quarterly Financials (Consolidated)**

| (Rs cr) | Q4FY18 | Q4FY17 | YoY Growth % | Q3FY18 | QoQ Growth % |
|---|---|---|---|---|---|
| **Total Revenue** | **13,178** | **12,898** | *2.2* | **12,809** | *2.9* |
| **EBITDA** | **3,022** | **2,747** | *10.0* | **2,789** | *8.4* |
| EBITDA Margin (%) | 22.9 | 21.3 | 164bps | 21.8 | 116 bps |
| Depreciation | 429 | 259 | *65.6* | 431 | *(0.5)* |
| **EBIT** | **2,593** | **2,488** | *4.2* | **2,358** | *10.0* |
| Interest | 19 | 28 | *(32.1)* | 21 | *(9.5)* |
| Other Income | 302 | 285 | *5.9* | 270 | *11.9* |
| Exceptional Items | 0 | 0 | - | 0 | - |
| **PBT** | **2,876** | **2,745** | *4.8* | **2,607** | *10.3* |
| Tax | 646 | 275 | *134.9* | 532 | *21.4* |
| **PAT** | **2,230** | **2,470** | *(9.7)* | **2,075** | *7.5* |
| Minority Interest/P&L of Associates | 2 | (3) | - | 0 | - |
| **Reported PAT** | **2,228** | **2,473** | *(9.9)* | **2,075** | *7.4* |
| Adjustment | 0 | 0 | - | 0 | - |
| **Adj PAT** | **2,228** | **2,473** | *(9.9)* | **2,075** | *7.4* |
| No. of shares (cr) | 139.2 | 142.7 | *(2.5)* | 139.2 | - |
| EPS (Rs.) | **16.0** | **17.3** | *(7.6)* | **14.9** | *7.4* |

*Source: Company, In-house research*

## Healthy growth in revenue

HCL reported better than expected numbers in Q4FY18 with consolidated revenue increasing by 2.5% QoQ in USD terms. While, in CC terms, revenue growth stood at 1.2% QoQ. The growth was driven by IMS business (accounts for ~37% of revenue), which witnessed heathy growth of 2.5% QoQ in CC terms followed by E&RD (1.7%) and BPO services (5.3%) that helped to offset weakness in application services (down by 0.9% QoQ). Vertically the growth was broad based mainly led by financial services (2%), public services (4.1%) and telecommunications, media, publishing & entertainment (1.8%).

## Mode 2 & 3 services gaining significant scale

In order to evolve as next-generation technology services firm, HCL Technologies is working through its Mode 1-2-3 strategy.

Mode 1: Core Services - HCL delivers core services in the areas of applications, infrastructure, BPO and Engineering & R&D, leveraging DRYiCE autonomics and orchestration to transform clients' business and IT landscape making them "lean" and "agile".

Mode 2: Next Generation Services - HCL delivers experience-centric and outcome-oriented integrated offerings of Digital & Analytics, IoT WoRKS™, Cloud Native Services and Cyber-security & GRC services.

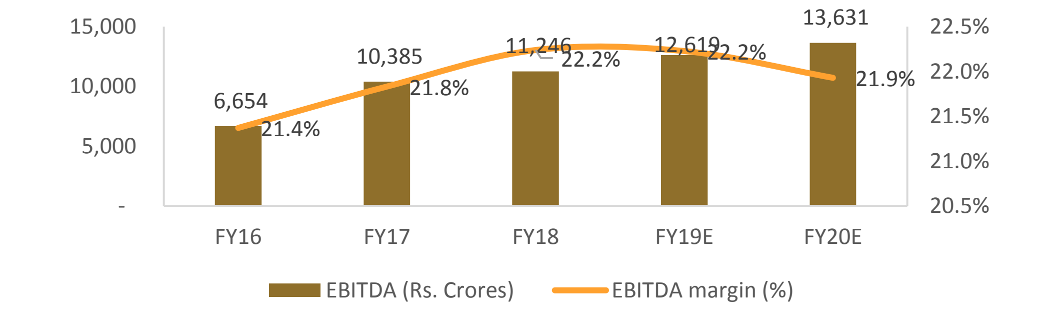
Mode 3: Products & Platforms - HCL continues to explore and enter into innovative IP-based partnerships, targeting specific next-generation opportunities apart from expansion of capabilities and markets for DRYiCE, the next-generation autonomics and orchestration products and platform.

Notably, Mode 2 & Mode 3 service offerings continued to gain pace with revenue growth of 41.5% in FY18 and accounted for 23.4% of revenue compared to 18.6% for FY17. The growth was powered by strength in digital, analytics and contribution from acquired entities. While Mode 1 services grew 5.7% in FY18 and constituted 76.6% of revenues. Further the company has signed 15 transformational deals during Q4FY18, spread across Mode 1, 2 and 3 services taking the overall transformational deals signed in FY18 to 63.

## Margin to come under pressure in FY20

In line with healthy revenue growth coupled with lower outsourcing cost, EBIT margin expanded by 127bps QoQ to 19.7% in Q4FY18. Importantly, management has maintained EBIT margin guidance of 19.5-20.5% for FY19E. Although we factor EBIT margin at the lower end of management guided range of 19.1% in FY19E, we factor 50bps decline in EBIT margin in FY20E owing to higher inorganic investments.

**EBITDA margin to improve by 30 bps over FY18-20E**

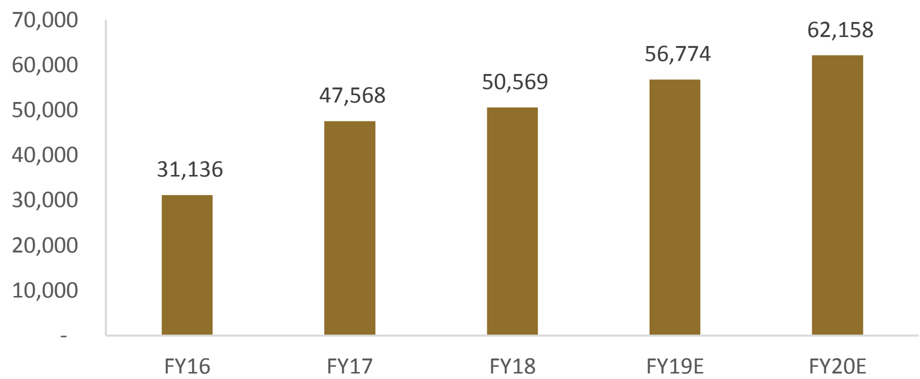



*Source: Company, In-house research*

## Revenue to grow at 11% CAGR over FY18-20E

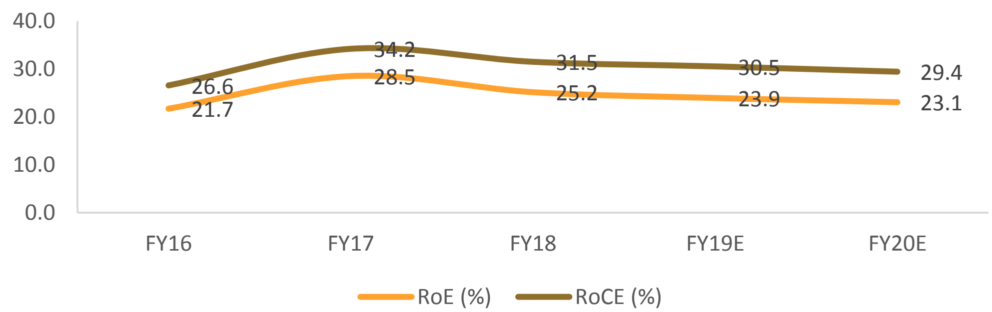
Continuing with its inorganic growth strategy, the company has made two new acquisitions in April 2018 - C3i Solutions and Actian Corp. While the acquisition of C3i Solutions would strengthen its capabilities in life sciences and consumer packaged goods (CPG) businesses, Actian Corp. would augment its capabilities in the data management products and platforms. Importantly, management has provided revenue growth guidance of 9.5-11.5% in CC terms for FY19 translating to 10.5%-12.5% in USD terms. This includes inorganic revenue contribution from recent acquisitions (C3i Solutions and Actian Corp) and implies equal contribution from both organic and inorganic businesses. Management believes incremental contribution from recent acquisitions would largely be offset by weakness in India business, pressure in renewals in its legacy business (due to automation & cloud migration) and contracting deal sizes in FY19. However, it is optimistic of revival in IMS business in H1FY19 driven by recent deal closures. We believe the management's tepid organic revenue growth guidance is disappointing given expected turnaround in the IMS business. We factor revenue CAGR of 11% over FY18-20E owing to healthy deal pipeline, traction in digital business and expected turnaround in IMS business.

**Revenue to grow at a CAGR of 11% over FY18-20E**




*Source: Company, In-house research*

**Return ratios trend**




*Source: Company, In-house research*

## Key risks

- Appreciation of INR against USD.
- Slowdown in global IT spend.
- Delay in recovery in core IMS business

## Profit & Loss Account (Consolidated)

| Y/E (Rs. Cr) | FY17 | FY18 | FY19E | FY20E |
|---|---|---|---|---|
| **Total operating Income** | **47,568** | **50,569** | **56,774** | **62,158** |
| Raw Material cost | 815 | 1,355 | 1,521 | 1,666 |
| Employee cost | 22,866 | 24,729 | 27,763 | 30,582 |
| Other operating expenses | 13,502 | 13,239 | 14,870 | 16,280 |
| **EBITDA** | **10,385** | **11,246** | **12,619** | **13,631** |
| Depreciation | 828 | 1,383 | 1,803 | 2,066 |
| **EBIT** | **9,556** | **9,863** | **10,816** | **11,565** |
| Interest cost | 89 | 69 | 74 | 74 |
| Other Income | 1,073 | 1,217 | 1,059 | 1,140 |
| **Profit before tax** | **10,541** | **11,011** | **11,801** | **12,631** |
| Tax | 1,936 | 2,302 | 2,596 | 2,779 |
| **Profit after tax** | **8,604** | **8,709** | **9,205** | **9,852** |
| Minority Interests | 0 | 1 | 1 | 1 |
| P/L from Associates | 2 | 13 | 14 | 16 |
| **Adjusted PAT** | **8,606** | **8,721** | **9,218** | **9,867** |
| E/o income / (Expense) | - | - | - | - |
| **Reported PAT** | **8,606** | **8,721** | **9,218** | **9,867** |

## Balance Sheet (Consolidated)

| Y/E (Rs. Cr) | FY17 | FY18 | FY19E | FY20E |
|---|---|---|---|---|
| Paid up capital | 285 | 278 | 278 | 278 |
| Reserves and Surplus | 32,664 | 36,108 | 40,316 | 44,672 |
| **Net worth** | **32,950** | **36,386** | **40,594** | **44,950** |
| Minority interest | 173 | - | 1 | 2 |
| Total Debt | 445 | 380 | 380 | 380 |
| Other non-current liabilities | 923 | 1,158 | 1,158 | 1,158 |
| **Total Liabilities** | **34,490** | **37,924** | **42,134** | **46,490** |
| Total fixed assets | 8,732 | 11,954 | 12,651 | 13,585 |
| Capital WIP | 448 | 320 | 320 | 320 |
| Goodwill | 6,504 | 6,799 | 6,799 | 6,799 |
| Investments | 1,306 | 2,660 | 3,660 | 4,660 |
| Net Current assets | 14,045 | 12,136 | 14,649 | 17,071 |
| Deferred tax assets (Net) | 1,652 | 1,803 | 1,803 | 1,803 |
| Other non-current assets | 1,804 | 2,252 | 2,252 | 2,252 |
| **Total Assets** | **34,490** | **37,924** | **42,134** | **46,490** |

## Cash Flow Statement (Consolidated)

| Y/E (Rs. Cr) | FY17 | FY18E | FY19E | FY20E |
|---|---|---|---|---|
| **Pretax profit** | 10,543 | 11,024 | 11,815 | 12,647 |
| Depreciation | 828 | 1,383 | 1,803 | 2,066 |
| Chg. in Working Capital | 321 | (3,481) | (1,397) | (1,191) |
| Others | (690) | (1,148) | (985) | (1,066) |
| Tax paid | (2,007) | (2,386) | (2,596) | (2,779) |
| **Cash flow from operating activities** | **8,995** | **5,392** | **8,641** | **9,677** |
| Capital expenditure | (3,922) | (4,477) | (2,500) | (3,000) |
| Chg. in investments | (490) | (1,354) | (1,000) | (1,000) |
| Other investing cashflow | (10,049) | 1,217 | 1,059 | 1,140 |
| **Cash flow from investing activities** | **(14,461)** | **(4,615)** | **(2,441)** | **(2,860)** |
| Equity raised/(repaid) | 0 | (7) | - | - |
| Debt raised/(repaid) | 10,249 | (65) | - | - |
| Dividend paid | (3,385) | (2,004) | (5,010) | (5,511) |
| Other financing activities | (752) | (69) | (74) | (74) |
| **Cash flow from financing activities** | **6,111** | **(2,145)** | **(5,084)** | **(5,585)** |
| Net chg in cash | 645 | (1,368) | 1,116 | 1,232 |

## Key Ratios (Consolidated)

| Y/E | FY17 | FY18 | FY19E | FY20E |
|---|---|---|---|---|
| **Growth (%)** | | | | |
| Net Sales | 52.8 | 6.3 | 12.3 | 9.5 |
| EBITDA | 56.1 | 8.3 | 12.2 | 8.0 |
| Net profit | 53.6 | 1.3 | 5.7 | 7.0 |
| **Margin (%)** | | | | |
| EBITDA | 21.8 | 22.2 | 22.2 | 21.9 |
| EBIT | 20.1 | 19.5 | 19.1 | 18.6 |
| NPM | 18.1 | 17.2 | 16.2 | 15.9 |
| **Return Ratios (%)** | | | | |
| RoE | 28.5 | 25.2 | 23.9 | 23.1 |
| RoCE | 34.2 | 31.5 | 30.5 | 29.4 |
| **Per share data (Rs.)** | | | | |
| EPS | 60.3 | 62.7 | 66.2 | 70.9 |
| DPS | 23.7 | 12.0 | 30.0 | 33.0 |
| **Valuation(x)** | | | | |
| P/E | 14.8 | 14.2 | 13.4 | 12.6 |
| EV/EBITDA | 11.4 | 10.7 | 9.4 | 8.6 |
| EV/Net Sales | 2.5 | 2.4 | 2.1 | 1.9 |
| P/B | 3.9 | 3.4 | 3.1 | 2.8 |
| **Turnover Ratios (x)** | | | | |
| Net Sales/Total Assets | 1.1 | 1.1 | 1.1 | 1.1 |
| Sales/Working Capital | 9.1 | 7.7 | 6.4 | 6.1 |

**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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