

BUY

TP: Rs 730 | ▲ 17%

HCL TECHNOLOGIES

| IT Services

| 17 July 2020

Upbeat margin outlook

HCL Tech (HCLT) reported a sharp 7.2% QoQ CC topline decline but resilient EBIT margins of 20.5% in Q1FY21. Mode-1 business slowdown was a drag on growth. The company managed to bag 11 large transformation deals in a difficult quarter. Given strong FY21 margin guidance (19.5-20.5%), we raise FY21/FY22 EPS by 9%/1%. Rolling valuations over, we have a new Jun'21 TP of Rs 730 (vs. Rs 680). We believe the company's strong software business, healthy deal wins and cloud/infrastructure expertise offer good midterm growth visibility. BUY.

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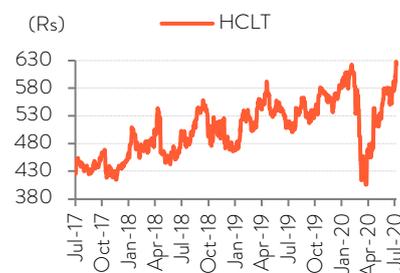
Margins resilient: HCLT's dollar revenue decline of 7.4% QoQ was broadly in line with our/street estimates (-7%) and stemmed partly from offshoring of large deals and supply constraints, besides the Covid-led demand slowdown. Operationally, HCLT outperformed estimates with a 20.5% EBIT margin (17.3% est.), down 40bps QoQ. This was the result of tight control over SG&A cost which dipped 30bps (as a % of sales). Automation, offshoring and a Mode-3 pivot aided margins. Mode-1 revenues declined 9.5% CC. Mode-3, the product and platforms segment, that was expected to be resilient also registered a 4.7% fall.

Ticker/Price	HCLT IN/Rs 623
Market cap	US\$ 22.6bn
Shares o/s	2,713mn
3M ADV	US\$ 42.4mn
52wk high/low	Rs 652/Rs 375
Promoter/FPI/DII	60%/27%/13%

Source: NSE

Pipeline grows QoQ: HCLT won 11 net new transformational deals in Q1 across the telecom, financial services, manufacturing, life sciences and healthcare verticals. Net new TCV increased, YoY. The deal pipeline swelled 40% QoQ, contributed by wins in life sciences, technology and financial services. In addition, renewals were robust. HCLT sees continued vendor consolidation momentum as opportunity for gaining market share.

STOCK PERFORMANCE



Source: NSE

Strong margin guidance: The pandemic-led demand slowdown has stabilised and management believes Q1 was the trough. Cyber-security, cloud and ecommerce are gaining momentum. HCLT has guided for a 2.3-0.8% YoY CC revenue decline and operating margin in the range 19.5-20.5% for FY21.

KEY FINANCIALS

Y/E 31 Mar	FY19A	FY20A	FY21E	FY22E	FY23E
Total revenue (Rs mn)	604,280	706,780	741,066	827,812	905,901
EBITDA (Rs mn)	140,020	166,930	189,568	212,819	235,768
Adj. net profit (Rs mn)	99,757	110,940	119,522	131,738	149,253
Adj. EPS (Rs)	36.7	40.9	44.0	48.5	55.0
Adj. EPS growth (%)	16.3	11.5	7.7	10.2	13.3
Adj. ROAE (%)	25.4	23.7	21.8	21.5	21.8
Adj. P/E (x)	17.0	15.2	14.1	12.8	11.3
EV/EBITDA (x)	12.0	10.0	8.9	7.8	6.6

Source: Company, BOBCAPS Research

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Other key highlights

- Software business run-rate approaching target:** Bigfix and Appscan saw their footprint increase significantly in Q1FY21. Performance of IBM products has been stable over the last three quarters. Covid-19 had a limited impact because of strong customer relationships and a diversified software business mix. Also, new demand-use cases coming up post pandemic in the areas of ecommerce, digital marketing, customer experience and cybersecurity have led to stable demand for software business products.

Last three quarters run-rate from the IBM product suite has reached US\$ 600mn, inching closer to the target of US\$ 625mn. HCLT completed installment payment of US\$ 812.5mn towards IBM products in Q1.

- Advantage from vendor consolidation:** HCLT sees an opportunity for deal wins arising out of vendor consolidation. Low hanging fruit are: (1) long-tail consolidation, (2) accounts requiring digital transformation where HCLT does not have sizable wallet share, and (3) replacement of a large incumbent vendor by competitive pricing.
- Mode-2 and 3 margin erosion:** EBIT margin contracted ~40bps QoQ in Q1, partially owing to margin erosion in Mode-2 and 3 segments. Mode-3 had higher depreciation and Mode-2 also saw one-time costs, flowing through from Q4FY20. Overall, EBIT margin saw headwinds of: (1) -70bps from higher depreciation of the IBM product investment, and (2) -12bps from increased R&D – these were offset by tailwinds of +40bps from decreased SG&A cost.
- Engineering and R&D (ER&D) segment impacted:** ER&D services segment saw a significant decline of 9% QoQ, followed by IT and business services which dropped 7.9%. Asset-heavy segments within the ER&D business, i.e. airline, automotive and industry equipment manufacturing clients, were hit by the lockdown. The asset-light segment, i.e. semiconductor and telecom clients, saw limited impact from Covid-19. Management expects recovery from Q2FY21 onwards in the segment.
- Partnership with Temenos:** HCLT has signed an agreement with banking software solutions provider Temenos for marketing and supporting the latter's multi-experience development platform (MXDP) to non-BFSI clients. The agreement is exclusive for seven years and HCLT will be paying US\$ 80mn to Temenos over the agreement period. The partnership complements its Mode-3 pivot strategy.

HCLT has been able to localise its US workforce by hiring 67.8% of employees locally

- **Miscellaneous:** (1) Among verticals, the sharpest QoQ decline came from manufacturing/media & entertainment/retail which declined 19%/15.2%/9.2%. BFSI fared better with a 1.7% dip. Europe among geographies contracted by 8.7%, followed by a 6.9% decline from the US. (2) The board announced dividend of Rs 2/sh, Q1FY21 being the 70th consecutive quarter of dividend payout. (3) Top 5 client revenues declined 14.7% QoQ.

FIG 1 – QUARTERLY PERFORMANCE

(Rs mn)	Q1FY21	Q1FY20	YoY (%)	Q4FY20	QoQ (%)	FY20	FY19	YoY (%)
Revenues (US\$ mn)	2,356	2,364	(0.3)	2,543	(7.4)	9,749	8,632	12.9
Revenue	178,410	164,250	8.6	185,900	(4.0)	703,840	604,280	16.5
Operating Expenditure	132,750	130,250	1.9	138,700	(4.3)	535,950	464,260	15.4
Cost of revenues	107,280	109,200	(1.8)	111,510	(3.8)	438,600	389,810	12.5
as % of sales	60.1	66.5	-	60.0	-	62.3	64.5	-
SG&A expenses	25,470	21,050	21.0	27,190	(6.3)	97,350	74,450	30.8
as % of sales	14.3	12.8	-	14.6	-	13.8	12.3	-
EBITDA	45,660	34,000	34.3	47,200	(3.3)	167,890	140,020	19.9
Depreciation	9,060	5,950	-	8,390	-	29,460	21,480	37.2
EBIT	36,600	28,050	30.5	38,810	(5.7)	138,430	118,540	16.8
Other Income	2,050	1,280	-	(130)	-	3,170	7,720	(58.9)
PBT	38,650	29,330	31.8	38,680	(0.1)	141,600	126,260	12.1
Total Tax	9,290	7,050	-	7,070	-	31,760	24,810	28.0
Adjusted PAT	29,360	22,280	31.8	31,610	(7.1)	109,840	101,450	8.3
(Profit)/loss from JV's/Ass/MI	(130)	(80)	-	(80)	-	(370)	(220)	-
APAT after MI	29,230	22,200	31.7	31,530	(7.3)	109,470	101,230	8.1
Extra ordinary items	0	0	-	0	-	0	0	-
Reported PAT	29,230	22,200	31.7	31,530	(7.3)	109,470	101,230	8.1
Reported EPS	10.8	8.2	31.7	11.6	(7.3)	40	37	9.7
Margins (%)			(bps)		(bps)			(bps)
EBITDA	25.6	20.7	490	25.4	20	23.9	23.2	70
EBIT	20.5	17.1	340	20.9	(40)	19.7	19.6	10
EBT	21.7	17.9	380	20.8	90	20.1	20.9	(80)
PAT	16.4	13.5	290	17.0	(60)	15.6	16.8	(120)
Effective Tax rate	24.0	24.0	-	18.3	580	22.4	19.6	280

Source: BOBCAPS Research

FIG 2 – OPERATING METRICS

	Q1FY21 (% Contr. to Revenue)	Growth (%)	
		QoQ	YoY
Revenue by Business Segment (%)			
Mode 1	63.4	(9.8)	(10.1)
Mode 2	20.3	(2.1)	7.6
Mode 3	16.2	(4.4)	48.1
Revenue by Geography (%)			
US	63.7	(6.9)	(6.2)
Europe	28.3	(8.7)	8.9
Asia Pacific	8	(5.0)	26.6
Revenue by Service Offering (%)			
IT and Business Services	70.2	(7.9)	(7.1)
Engineering and R&D Services	16	(9.1)	(5.6)
Products & Platforms	13.8	(2.4)	76.4
Revenue by Industry (%)			
BFSI	22.4	(1.7)	10.0
Retail	10	(9.2)	4.9
Media, Publishing & Entertainment	7.6	(15.2)	(5.3)
Life Sciences	13.7	1.5	6.7
Energy Utilities - Public Sector	11	(7.4)	4.4
Manufacturing	18.1	(19.0)	(9.3)
Technology Services	17.2	(1.7)	(9.3)
Client Concentration (%)			
Top 5	13.9	(14.7)	(18.5)
Top 10	20.9	(12.0)	(13.6)
Top 20	30.8	(11.1)	(8.1)
Employee Metrics			
	Q1FY21	Q4FY20	Q1FY20
Quarterly Annualised attrition rate (%)	19.0	24.1	29.5
Total Employees	150,287	150,423	143,900
Gross Addition	7,005	10,278	16,332
Net Addition	(136)	1,250	5,935
Revenue by Contract Type (%)			
Time & material	33.3	31.7	36.5
Fixed Price	66.7	68.3	63.5

Source: BOBCAPS Research

Valuation methodology

We increase FY21/FY22 EPS estimates by 9%/1% and introduce FY23 forecasts. On rolling valuations forward, our Jun'21 target price stands revised up to Rs 730 (from Rs 680), set at a largely unchanged target P/E multiple of 14.5x (a 30% discount to that for TCS). Our TP revision factors in HCLT's strong margin guidance for FY21 and its commitment towards enhancing its Mode-2 & 3 portfolios (which command higher margins).

Reiterate BUY as we believe there is relatively higher near-to-mid-term growth visibility than peers on the back of:

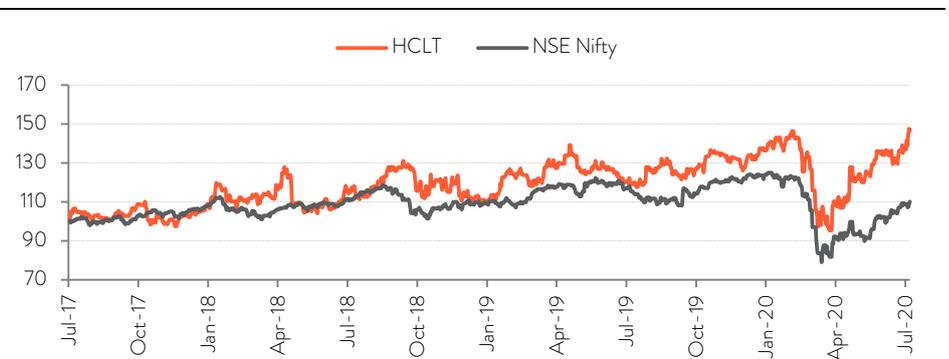
- its growing software (Mode-3) business which forms 16.2% of revenue and is relatively immune to Covid-led volatility,
- healthy large deal wins (11 contracts won in Q1FY21), and
- its IMS heritage which offers unique positioning to leverage the cloud migration opportunity accelerated by the pandemic.

FIG 3 – REVISED ESTIMATES

(Rs mn)	FY21E			FY22E			FY23E
	Old	New	Change (%)	Old	New	Change (%)	New
Revenues (US\$ mn)	10,017	9,711	(3.1)	10,791	10,613	(1.6)	11,614
YoY growth (%)	0.8	(2.3)	-	7.7	9.3	-	9.4
Revenues	766,331	741,066	(3.3)	841,681	827,812	(1.6)	905,901
EBITDA	178,353	189,568	6.3	207,823	212,819	2.4	235,768
EBITDA margins (%)	23.3	25.6	-	24.7	25.7	-	26.0
EBIT margins (%)	18.3	20.0	-	19.8	20.3	-	20.7
Net profits	109,375	119,522	9.3	130,801	131,738	0.7	149,253
EPS (Rs)	40.3	44.0	9.3	48.2	48.5	0.7	55.0

Source: BOBCAPS Research

FIG 4 – RELATIVE STOCK PERFORMANCE



Source: NSE

Key risks

Downside risks to our estimates include:

- above-expected revenue contraction in IMS due to automation,
- above-expected HCL Software client attrition,
- an inability to renew existing contracts,
- a sharp decline in IT demand, and
- adverse currency movement.

FINANCIALS

Income Statement

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Total revenue	604,280	706,780	741,066	827,812	905,901
EBITDA	140,020	166,930	189,568	212,819	235,768
Depreciation	21,480	28,400	41,518	45,014	47,808
EBIT	118,540	138,530	148,050	167,805	187,959
Net interest income/(expenses)	(1,693)	0	0	0	0
Other income/(expenses)	7,720	1,790	3,444	3,283	5,875
Exceptional items	0	0	0	0	0
EBT	124,567	140,320	151,493	171,088	193,835
Income taxes	24,810	29,380	31,972	39,350	44,582
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	0	0	0	0	0
Reported net profit	99,757	110,940	119,522	131,738	149,253
Adjustments	0	0	0	0	0
Adjusted net profit	99,757	110,940	119,522	131,738	149,253

Balance Sheet

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Accounts payables	0	0	0	0	0
Other current liabilities	126,860	259,090	259,373	289,734	317,065
Provisions	0	0	14,821	16,556	18,118
Debt funds	39,860	50,930	50,930	50,930	50,930
Other liabilities	0	0	0	0	0
Equity capital	2,812	2,812	2,812	2,812	2,812
Reserves & surplus	414,888	514,048	576,056	644,401	721,834
Shareholders' fund	417,700	516,860	578,868	647,213	724,646
Total liabilities and equities	584,420	826,880	903,992	1,004,434	1,110,759
Cash and cash eq.	59,290	48,430	120,879	250,492	352,596
Accounts receivables	146,100	177,720	192,880	204,118	223,373
Inventories	0	0	0	0	0
Other current assets	37,160	79,030	88,928	82,781	90,590
Investments	58,520	105,680	105,680	105,680	105,680
Net fixed assets	132,396	62,440	40,000	14,486	(13,822)
CWIP	0	0	0	0	0
Intangible assets	102,564	294,210	294,210	294,210	294,210
Deferred tax assets, net	0	0	0	0	0
Other assets	52,930	64,650	66,696	57,947	63,413
Total assets	588,960	832,160	909,273	1,009,714	1,116,040

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY19A	FY20A	FY21E	FY22E	FY23E
Net income + Depreciation	120,740	139,340	161,040	176,752	197,061
Interest expenses	(4,480)	(1,790)	(3,444)	(3,283)	(5,875)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(24,660)	47,020	(12,000)	35,754	(3,637)
Other operating cash flows	(1,936)	(40,905)	0	0	0
Cash flow from operations	89,664	143,665	145,597	209,222	187,548
Capital expenditures	(34,340)	(150,090)	(19,078)	(19,500)	(19,500)
Change in investments	5,200	47,160	0	0	0
Other investing cash flows	(3,604)	1,790	3,444	3,283	5,875
Cash flow from investing	(32,744)	(101,140)	(15,634)	(16,217)	(13,625)
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	36,230	0	0	0	0
Interest expenses	(39,860)	0	0	0	0
Dividends paid	(10,990)	(53,384)	(57,514)	(63,392)	(71,820)
Other financing cash flows	0	0	0	0	0
Cash flow from financing	(14,620)	(53,384)	(57,514)	(63,392)	(71,820)
Changes in cash and cash eq.	42,300	(10,859)	72,449	129,613	102,103
Closing cash and cash eq.	59,290	48,430	120,879	250,492	352,596

Per Share

Y/E 31 Mar (Rs)	FY19A	FY20A	FY21E	FY22E	FY23E
Reported EPS	36.7	40.9	44.0	48.5	55.0
Adjusted EPS	36.7	40.9	44.0	48.5	55.0
Dividend per share	14.7	16.4	17.6	19.4	22.0
Book value per share	153.5	190.5	213.3	238.5	267.0

Valuations Ratios

Y/E 31 Mar (x)	FY19A	FY20A	FY21E	FY22E	FY23E
EV/Sales	2.8	2.4	2.3	2.0	1.7
EV/EBITDA	12.0	10.0	8.9	7.8	6.6
Adjusted P/E	17.0	15.2	14.1	12.8	11.3
P/BV	4.1	3.3	2.9	2.6	2.3

DuPont Analysis

Y/E 31 Mar (%)	FY19A	FY20A	FY21E	FY22E	FY23E
Tax burden (Net profit/PBT)	80.1	79.1	78.9	77.0	77.0
Interest burden (PBT/EBIT)	105.1	101.3	102.3	102.0	103.1
EBIT margin (EBIT/Revenue)	19.6	19.6	20.0	20.3	20.7
Asset turnover (Revenue/Avg TA)	112.6	99.5	85.1	86.3	85.2
Leverage (Avg TA/Avg Equity)	1.4	1.5	1.6	1.6	1.5
Adjusted ROAE	25.4	23.7	21.8	21.5	21.8

Source: Company, BOBCAPS Research | Note: TA = Total Assets

Ratio Analysis

Y/E 31 Mar	FY19A	FY20A	FY21E	FY22E	FY23E
YoY growth (%)					
Revenue	19.5	17.0	4.9	11.7	9.4
EBITDA	22.4	19.2	13.6	12.3	10.8
Adjusted EPS	16.3	11.5	7.7	10.2	13.3
Profitability & Return ratios (%)					
EBITDA margin	23.2	23.6	25.6	25.7	26.0
EBIT margin	19.6	19.6	20.0	20.3	20.7
Adjusted profit margin	16.5	15.7	16.1	15.9	16.5
Adjusted ROAE	25.4	23.7	21.8	21.5	21.8
ROCE	25.2	23.9	22.7	27.0	33.2
Working capital days (days)					
Receivables	81	84	91	88	86
Inventory	0	0	0	0	0
Payables	92	130	172	163	165
Ratios (x)					
Gross asset turnover	4.8	7.3	14.5	30.4	2,730.7
Current ratio	2.3	1.4	1.7	1.9	2.2
Net interest coverage ratio	NA	NA	NA	NA	NA
Adjusted debt/equity	0.0	0.0	(0.1)	(0.3)	(0.4)

Source: Company, BOBCAPS Research

Disclaimer

Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

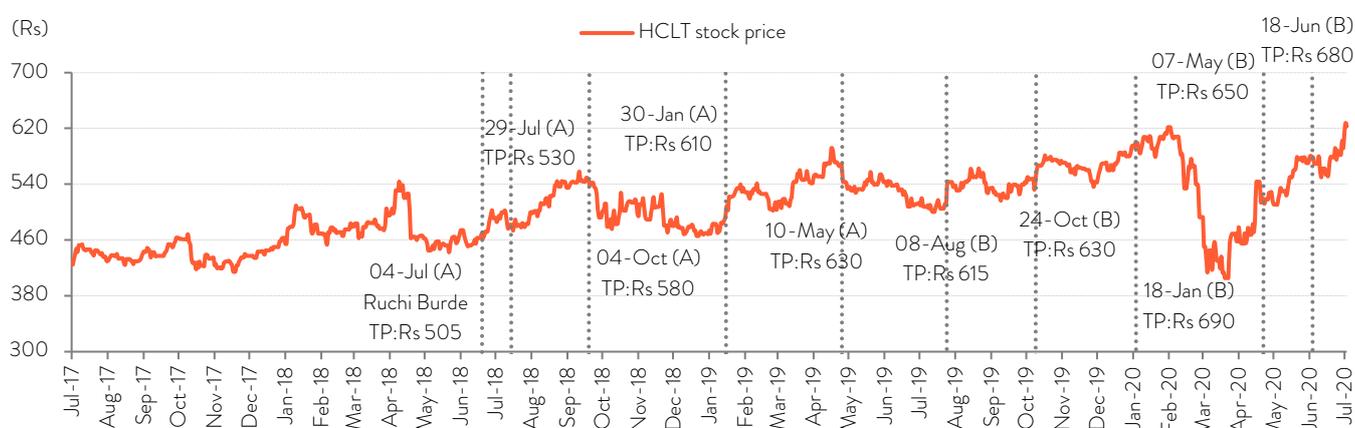
ADD – Expected return from >+5% to +15%

REDUCE – Expected return from -5% to +5%

SELL – Expected return <-5%

Note: Recommendation structure changed with effect from 1 January 2018 (Hold rating discontinued and replaced by Add / Reduce)

HISTORICAL RATINGS AND TARGET PRICE: HCL TECHNOLOGIES (HCLT IN)



B – Buy, A – Add, R – Reduce, S – Sell

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