

**ADD**

TP: Rs 320 | ▲ 8%

**HEXWARE  
TECHNOLOGIES**

| IT Services

| 30 April 2020

## Cloudy near-term outlook; cut to ADD

**Challenged related to Covid-19 marred Hexaware's (HEXW) Q1CY20 operating performance (revenue down 1.1% QoQ CC) and are expected to worsen in Q2, making for a gloomy near-term outlook. Strong new deal wins and a rebound in BFSI revenue growth offered some respite. We cut CY21/CY22 EPS estimates by 20%/16%, lower our Mar'21 TP to Rs 320 (from Rs 440) based on a revised FY22E P/E of 14x (from 15.5x), and downgrade the stock from BUY to ADD on pandemic-led uncertainties.**

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**Weak operating show:** HEXW's Q1CY20 performance was underwhelming. Revenues declined 1.1% QoQ CC owing to a 200-300bps adverse impact in the wake of Covid-19. EBITDA margin (post RSU) contracted 50bps QoQ (+20bps YoY) to 15.2% amid headwinds of ~120bps from the pandemic.

Ticker/Price	HEXW IN/Rs 296
Market cap	US\$ 1.2bn
Shares o/s	302mn
3M ADV	US\$ 1.8mn
52wk high/low	Rs 456/Rs 202
Promoter/FPI/DII	71%/15%/14%

Source: NSE

**Strong contract wins and resilient BFS performance:** The company won net new deal TCW worth US\$ 69mn, marking one of its best quarters for new signings. Despite a drag in one of its large BFS accounts, BFS revenue increased 2.1% QoQ (after a 6.4% QoQ decline in the Dec'19 quarter). Management indicated that challenges in the large BFS account have bottomed out and the client is expected to resume its growth trajectory in the Jun'20 quarter.

## STOCK PERFORMANCE



Source: NSE

**Near-term outlook gloomy:** Multiple Covid-19-related challenges such as demand contraction, pricing discounts, payment term concessions and supply/delivery constraints render the near-term growth outlook bleak and unpredictable. Consequently, management has suspended annual revenue and operating margin guidance, akin to several industry peers.

## KEY FINANCIALS

Y/E 31 Dec	CY18A	CY19P	CY20E	CY21E	CY22E
Total revenue (Rs mn)	46,477	55,825	60,990	66,028	73,946
EBITDA (Rs mn)	7,335	8,778	9,067	10,217	11,440
Adj. net profit (Rs mn)	5,833	6,748	5,927	6,603	7,392
Adj. EPS (Rs)	19.3	22.3	19.6	21.8	24.4
Adj. EPS growth (%)	16.6	15.4	(12.2)	11.4	11.9
Adj. ROAE (%)	26.5	26.2	19.9	19.4	18.9
Adj. P/E (x)	15.3	13.3	15.1	13.6	12.1
EV/EBITDA (x)	11.5	9.4	9.3	8.4	7.0

Source: Company, BOBCAPS Research

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## Earnings call highlights

- Revenue declines amid lower utilisation:** HEXW's Q1CY20 revenue fell 1.1% QoQ CC, with a 200-300bps adverse impact in the wake of Covid-19. America/Asia Pacific dollar revenues declined 1.8%/2.8% QoQ, while Europe saw flat growth (0.1%). Lower utilisation hurt growth, coming in at 76.5% in Q1CY20, a decline of 190bps QoQ on a lower base of Q4CY19 (due to furloughs). Utilisation is expected to weaken further in Q2 but should be on par with the industry.

The BPO segment is also facing challenges due to the work-from-home environment. HEXW was working on a strategy to pivot its IMS business to high-end projects and consulting business for higher margins, which received a setback from Covid-19 (-16.5% QoQ). However, the business is expected to bounce back once the uncertainty recedes. HEXW saw an increase in new wins in the early part of the year – net new deal wins for Q1 stood at US\$ 69mn.

- BFSI outperforms among verticals:** Growth during the quarter was supported by HPS/BFSI revenues which increased 3.1%/2.1% QoQ in dollar terms. BFSI grew on account of month-on-month volume recovery from the top client which had declined sharply in Q4CY19. Asset servicing and mortgage are doing well with a month-on-month increase in volumes. Asset management will see a delayed impact in Q3CY20.

Dollar revenues declined QoQ from TTHL (travel and hospitality: -5.4%), healthcare and insurance (-5.8%), and manufacturing and consumers (-5.3%). The TTHL vertical is seeing challenges from smaller clients while larger clients are structurally more stable. HEXW has made provisions due to bankruptcy at a smaller TTHL client.

- Margins contract:** EBITDA margin (post-RSU) contracted 50bps QoQ (+20bps YoY) amid headwinds of ~120bps from the pandemic, partly set off by 100bps of positive impact from operational efficiency measures. SG&A costs (ex-RSU) declined 6.8% QoQ. Clients are looking for cost reduction which will further affect margins in Q2. Management indicated that it might take 3-4 quarters for the EBIT margin to recover to 13-15% levels.
- Top clients:** Non-top 10 client revenues declined 4.5% QoQ. The number of clients in the US\$ 1mn-5mn and >US\$ 1mn buckets declined by four and three respectively. HEXW's account mining strategy is progressing well but its 'hunting' strategy has fallen behind, especially in the US due to the lockdown.
- Mobiquity:** Growth in digital, automation and customer experience transformation were fueled by both Mobiquity and the organic portfolio.

- **Covid-19 impact**
  - HEXW had shifted to the work-from-home model before the government announced the lockdown, with 99% of IT employees and 80% of BPS employees currently migrated to this model.
  - The company's focus is on maintaining client relationships during this period. Customer delight is higher (45% of respondents) as compared to the rest of the industry (28%) based on a recent customer satisfaction survey conducted by HEXW.
  - In light of the uncertainty due to the pandemic, management has suspended guidance. In Q4CY19, it had guided for 15-17% revenue growth for CY20. Quarterly dividend announcements have also been suspended. Final dividend announced with Q4CY19 result is awaiting shareholder's approval in AGM which was postponed due to current lockdown situation.
  - Q2CY20 will see a major impact from lower demand and increased management-related costs due to Covid-19. The retail, automotive and manufacturing verticals will see a longer-term impact.
- **Post-pandemic outlook:** Hi-tech and professional services will gain momentum. Customer experience transformation, automation and cloudification should see renewed traction as these will graduate from being discretionary spends to business continuity spends. Delivering a touchless experience will be a priority. Half of the workforce will continue to work from home.
- **Miscellaneous**
  - Cash has gone up QoQ, with US\$ 23mn coming from operations. HEXW had taken a US\$ 50mn credit line to fund the Mobiquity acquisition and recently paid the first installment towards this purchase. Despite the ongoing uncertainty, management believes there is enough liquidity and working capital for now. Mobiquity will not be affected as work on customer experience transformation has become a continuity, rather than discretionary, spend.
  - Investment in the marketing and sales workforce increased QoQ.
  - Q1CY20 saw a 70bps QoQ drop in attrition to 15.1%.

**FIG 1 – MAR'20 QUARTER PERFORMANCE**

(Rs mn)	Q1CY20	Q1CY19	YoY (%)	Q4CY19	QoQ (%)
<b>Revenues (US\$ mn)</b>	<b>211</b>	<b>180</b>	<b>17.2</b>	<b>214</b>	<b>(1.5)</b>
<b>Revenue</b>	<b>15,418</b>	<b>12,640</b>	<b>22.0</b>	<b>15,288</b>	<b>0.8</b>
Operating Expenditure	13,082	10,753	21.7	12,891	1.5
Cost of revenues	10,415	8,781	18.6	10,234	1.8
as % of sales	67.6	69.5	-	66.9	-
SG&A expenses	2,667	1,972	35.2	2,658	0.3
as % of sales	17.3	15.6	-	17.4	-
<b>EBITDA</b>	<b>2,336</b>	<b>1,887</b>	<b>23.8</b>	<b>2,397</b>	<b>(2.5)</b>
Depreciation	518	148	-	356	-
<b>EBIT</b>	<b>1,818</b>	<b>1,739</b>	<b>4.6</b>	<b>2,041</b>	<b>(10.9)</b>
Other Income	328	(42)	-	(16)	-
<b>PBT</b>	<b>2,146</b>	<b>1,697</b>	<b>26.5</b>	<b>2,026</b>	<b>5.9</b>
Total Tax	397	312	-	351	-
Adjusted PAT	1,749	1,385	26.3	1,675	4.4
(Profit)/loss from JV's/Ass/MI	0	0	-	0	-
APAT after MI	1,749	1,385	26.3	1,675	4.4
Extra ordinary items	0	0	-	0	-
<b>Reported PAT</b>	<b>1,749</b>	<b>1,385</b>	<b>26.3</b>	<b>1,675</b>	<b>4.4</b>
Reported EPS	5.8	4.6	26.3	5.5	4.3
<b>Margins (%)</b>			<b>(bps)</b>		<b>(bps)</b>
EBITDA	15.2	14.9	20	15.7	(50)
EBIT	11.8	13.8	(200)	13.4	(160)
EBT	13.9	13.4	50	13.2	70
PAT	11.3	11.0	40	11.0	40
Effective Tax rate	18.5	18.4	10	17.3	120

Source: Company, BOBCAPS Research

**FIG 2 – MAR'20 OPERATING METRICS**

(In US\$ terms)	Q1CY20 (% Contr. to Revenue)	Growth (%)	
		QoQ	YoY
Net new deal wins (US\$ mn)	69	130.0	92
<b>Revenue by Vertical</b>			
BFSI	36.8	2.1	5.7
TTHL	9.9	(5.4)	22.2
Healthcare and Insurance	20.1	(5.8)	28.8
Manufacturing and Consumers	17.5	(5.3)	19.3
Professional Services	15.7	3.1	28.7
<b>Revenue by Service</b>			
ADM	42.5	3.6	44.4
EAS	8.3	(11.2)	2.4
Digital Assurance	15.9	0.4	6.5
Business Intelligence & Analytics	11.4	5.9	2.0
BPO	8.5	(0.4)	31.1
IMS	13.4	(16.5)	(11.8)
<b>Revenue by Geography</b>			
US	74.2	(1.8)	14.3
Europe	17.8	0.1	65.6
ROW	8.0	(2.8)	(17.0)
<b>Onsite-Offshore Revenue Mix</b>			
Onsite	61.6	0.3	12.8
Offshore	38.4	(4.6)	21.8
<b>Client Concentration</b>			
Top 5 clients	34.3	1.1	(3.6)
Top 10 clients	45.1	2.3	3.5
Non-Top 10 client revenues	54.9	(4.5)	31.6
Total Headcount	19,998	0	21

Source: Company, BOBCAPS Research

### Valuation methodology

We cut CY20/CY21/CY22 EPS estimates by 17%/20%/16% as we moderate revenue growth assumptions due to the effects of Covid-19 and Ind-AS 116 adoption effective CY20. Given the pandemic-induced uncertainty, we lower our target FY22E P/E multiple from 15.5x to 14x, leading to a revised Mar'21 target price of Rs 320 (Rs 440 earlier), and cut our rating from BUY to ADD. We prefer large-cap IT services players over midcap names in these volatile times.

**FIG 3 – REVISED ESTIMATES**

(Rs mn)	CY20E			CY21E			CY22E		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
Revenues (US\$ mn)	921	819	(11.1)	1039	880	(15.3)	1168	986	(15.6)
YoY growth (%)	16.1	3.2	-	12.8	7.5	-	12.4	12.0	-
Revenues	64,484	60,990	(5.4)	72,754	66,028	(9.2)	81,763	73,946	(9.6)
EBITDA	9,811	9,067	(7.6)	11,259	10,217	(9.3)	12,650	11,440	(9.6)
EBITDA margins (%)	15.2	14.9	-	15.5	15.5	-	15.5	15.5	-
EBIT	8,333.0	6,998	(16.0)	9,651.7	8,084	(16.2)	10,913	9,125	(16.4)
EBIT margins (%)	12.9	11.5	-	13.3	12.2	-	13.3	12.3	-
Net profits	7,136	5,927	(16.9)	8,214	6,603	(19.6)	8,815	7,392	(16.1)
EPS (Rs)	23.6	19.6	(17.0)	27.2	21.8	(19.6)	29.1	24.4	(16.1)

Source: BOBCAPS Research

**FIG 4 – RELATIVE STOCK PERFORMANCE**



Source: NSE

### Key risks

Downside risks to our estimates include:

- sharp adverse currency movements,
- above-expected loss of revenue due to the coronavirus outbreak, and
- an inability to replicate success in newly launched services.

## FINANCIALS

### Income Statement

Y/E 31 Dec (Rs mn)	CY18A	CY19P	CY20E	CY21E	CY22E
<b>Total revenue</b>	<b>46,477</b>	<b>55,825</b>	<b>60,990</b>	<b>66,028</b>	<b>73,946</b>
EBITDA	7,335	8,778	9,067	10,217	11,440
Depreciation	650	1,033	2,069	2,133	2,316
EBIT	6,685	7,745	6,998	8,084	9,125
Net interest income/(expenses)	0	0	0	0	0
Other income/(expenses)	580	212	338	119	58
Exceptional items	0	(170)	0	0	0
EBT	7,265	8,127	7,336	8,203	9,182
Income taxes	1,432	1,379	1,409	1,600	1,791
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	0	0	0	0	0
<b>Reported net profit</b>	<b>5,833</b>	<b>6,748</b>	<b>5,927</b>	<b>6,603</b>	<b>7,392</b>
Adjustments	0	0	0	0	0
<b>Adjusted net profit</b>	<b>5,833</b>	<b>6,748</b>	<b>5,927</b>	<b>6,603</b>	<b>7,392</b>

### Balance Sheet

Y/E 31 Dec (Rs mn)	CY18A	CY19P	CY20E	CY21E	CY22E
Accounts payables	0	0	0	0	0
Other current liabilities	6,425	11,304	11,697	12,663	14,181
Provisions	916	1,253	1,337	1,447	1,621
Debt funds	0	0	0	0	0
Other liabilities	76	45	45	45	45
Equity capital	595	597	597	597	597
Reserves & surplus	23,324	27,058	31,207	35,829	41,004
Shareholders' fund	23,919	27,655	31,804	36,426	41,600
<b>Total liabilities and equities</b>	<b>31,335</b>	<b>40,257</b>	<b>44,882</b>	<b>50,581</b>	<b>57,448</b>
Cash and cash eq.	8,205	2,466	5,498	12,233	17,858
Accounts receivables	8,031	9,796	11,697	10,854	12,156
Inventories	0	0	0	0	0
Other current assets	5,201	6,301	6,684	7,236	8,104
Investments	127	30	30	30	30
Net fixed assets	7,986	21,238	20,548	19,803	18,874
CWIP	2,244	863	863	863	863
Intangible assets	1,809	11,761	11,761	11,761	11,761
Deferred tax assets, net	1,784	1,437	1,437	1,437	1,437
Other assets	0	0	0	0	0
<b>Total assets</b>	<b>31,335</b>	<b>41,268</b>	<b>45,893</b>	<b>51,592</b>	<b>58,459</b>

Source: Company, BOBCAPS Research

**Cash Flows**

Y/E 31 Dec (Rs mn)	CY18A	CY19P	CY20E	CY21E	CY22E
Net income + Depreciation	6,325	7,781	7,996	8,736	9,708
Interest expenses	(53)	(212)	(338)	(119)	(58)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(1,166)	2,353	(1,808)	1,367	(477)
Other operating cash flows	382	(8,147)	0	0	0
<b>Cash flow from operations</b>	<b>5,487</b>	<b>1,775</b>	<b>5,850</b>	<b>9,984</b>	<b>9,173</b>
Capital expenditures	(606)	(5,701)	(1,378)	(1,388)	(1,388)
Change in investments	88	0	0	0	0
Other investing cash flows	590	212	338	119	58
<b>Cash flow from investing</b>	<b>72</b>	<b>(5,490)</b>	<b>(1,040)</b>	<b>(1,268)</b>	<b>(1,330)</b>
Equities issued/Others	4	0	0	0	0
Debt raised/repaid	0	0	0	0	0
Interest expenses	0	0	0	0	0
Dividends paid	(2,506)	(2,025)	(1,778)	(1,981)	(2,218)
Other financing cash flows	0	0	0	0	0
<b>Cash flow from financing</b>	<b>(2,502)</b>	<b>(2,025)</b>	<b>(1,778)</b>	<b>(1,981)</b>	<b>(2,218)</b>
<b>Changes in cash and cash eq.</b>	<b>3,057</b>	<b>(5,739)</b>	<b>3,032</b>	<b>6,735</b>	<b>5,625</b>
<b>Closing cash and cash eq.</b>	<b>8,205</b>	<b>2,466</b>	<b>5,498</b>	<b>12,233</b>	<b>17,858</b>

**Per Share**

Y/E 31 Dec (Rs)	CY18A	CY19P	CY20E	CY21E	CY22E
Reported EPS	19.3	22.3	19.6	21.8	24.4
Adjusted EPS	19.3	22.3	19.6	21.8	24.4
Dividend per share	8.0	5.6	4.9	5.5	6.1
Book value per share	79.3	91.4	105.2	120.4	137.5

**Valuations Ratios**

Y/E 31 Dec (x)	CY18A	CY19P	CY20E	CY21E	CY22E
EV/Sales	1.8	1.5	1.4	1.3	1.1
EV/EBITDA	11.5	9.4	9.3	8.4	7.0
Adjusted P/E	15.3	13.3	15.1	13.6	12.1
P/BV	3.7	3.2	2.8	2.5	2.2

**DuPont Analysis**

Y/E 31 Dec (%)	CY18A	CY19P	CY20E	CY21E	CY22E
Tax burden (Net profit/PBT)	80.3	83.0	80.8	80.5	80.5
Interest burden (PBT/EBIT)	108.7	104.9	104.8	101.5	100.6
EBIT margin (EBIT/Revenue)	14.4	13.9	11.5	12.2	12.3
Asset turnover (Revenue/Avg TA)	163.7	153.8	139.9	135.5	134.4
Leverage (Avg TA/Avg Equity)	1.3	1.4	1.5	1.4	1.4
Adjusted ROAE	26.5	26.2	19.9	19.4	18.9

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

**Ratio Analysis**

Y/E 31 Dec	CY18A	CY19P	CY20E	CY21E	CY22E
<b>YoY growth (%)</b>					
Revenue	17.9	20.1	9.3	8.3	12.0
EBITDA	11.9	19.7	3.3	12.7	12.0
Adjusted EPS	16.6	15.4	(12.2)	11.4	11.9
<b>Profitability &amp; Return ratios (%)</b>					
EBITDA margin	15.8	15.7	14.9	15.5	15.5
EBIT margin	14.4	13.9	11.5	12.2	12.3
Adjusted profit margin	12.6	12.1	9.7	10.0	10.0
Adjusted ROAE	26.5	26.2	19.9	19.4	18.9
ROCE	35.1	31.4	21.9	25.7	30.6
<b>Working capital days (days)</b>					
Receivables	53	58	64	62	57
Inventory	0	0	0	0	0
Payables	51	69	81	80	78
<b>Ratios (x)</b>					
Gross asset turnover	5.8	3.8	2.9	3.3	3.8
Current ratio	2.9	1.5	1.8	2.1	2.4
Net interest coverage ratio	NA	NA	NA	NA	NA
Adjusted debt/equity	(0.3)	(0.1)	(0.2)	(0.3)	(0.4)

Source: Company, BOBCAPS Research

## Disclaimer

### Recommendations and Absolute returns (%) over 12 months

**BUY** – Expected return >+15%

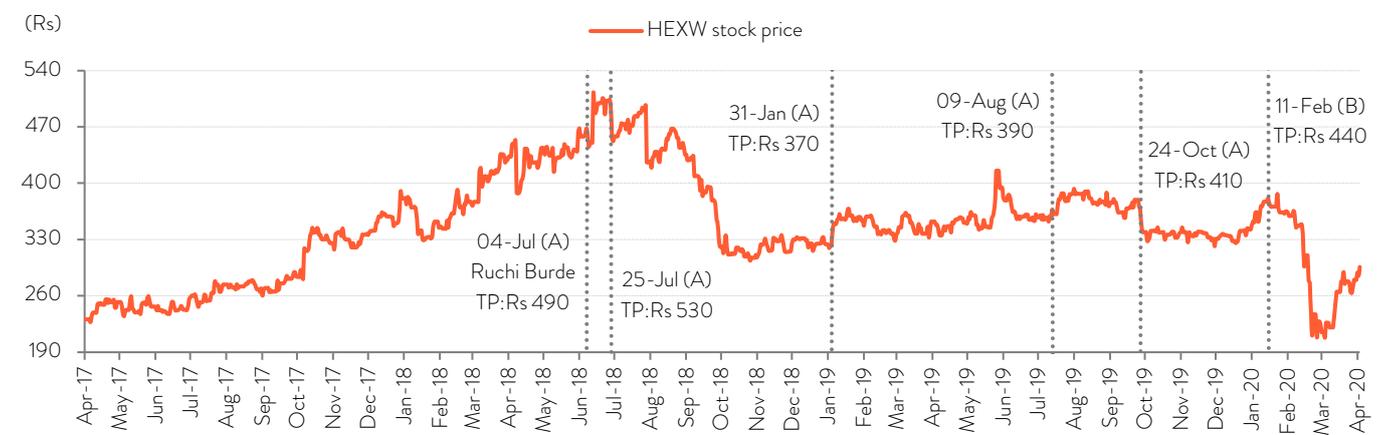
**ADD** – Expected return from >+5% to +15%

**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: HEXWARE TECHNOLOGIES (HEXW IN)



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

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