

BUY

TP: Rs 690 | ▲ 15%

HCL TECHNOLOGIES

IT Services

18 January 2020

IP business drives robust Q3

HCL Tech (HCLT) reported an above-expected operating performance in Q3FY20, supported by a modest beat on both revenue and margins. The products & platform business led the way, clocking 14.6% QoQ dollar revenue growth. Growth prospects look upbeat with management putting out more positive demand commentary than tier-1 peers. We raise FY21/FY22 EPS by 3% each as we increase margin assumptions. On rollover, we have a new Mar'21 TP of Rs 690 (vs. Rs 630 earlier), based on an unchanged target P/E of 14.2x.

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Operating performance robust: HCLT reported 2.1% QoQ CC revenue growth and 30bps QoQ EBIT margin expansion in Q3, both slightly ahead of our estimates.

IP business leads the way: Mode3 revenues inched up 10% QoQ in dollar terms and contributed 15.8% of revenue. Management indicated that the acquired IBM products reached desired revenue levels, marking improvement over the Q2FY20 tally of ~US\$ 105mn. Core business (mode1 + mode2) growth was soft at 1% QoQ in dollar terms, hobbled by higher furloughs and trimming of select low-profit accounts.

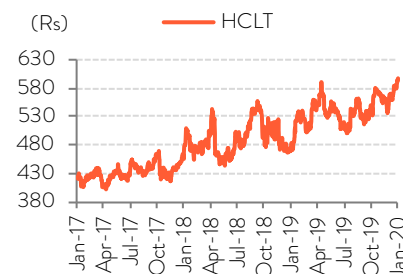
Refined guidance: Management narrowed the FY20 revenue guidance range to 16.5-17% YoY CC growth vs. 15-17% earlier. This builds in 10.5-11% organic growth and ~6% inorganic growth. EBIT margin guidance has also been refined to 19-19.5% vs. 18.5-19.5% earlier.

Deal wins soft: Unlike FY19, the company did not record any US\$ 1bn+ TCW signings in the current fiscal. Management indicated that deal wins in the Dec'19 quarter were slightly soft due to decision-making delays, but is confident of enhanced wins in the current quarter backed by a record deal pipeline.

Ticker/Price	HCLT IN/Rs 599
Market cap	US\$ 22.9bn
Shares o/s	2,713mn
3M ADV	US\$ 18.4mn
52wk high/low	Rs 602/Rs 469
Promoter/FPI/DII	60%/27%/13%

Source: NSE

STOCK PERFORMANCE



Source: NSE

KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
Total revenue (Rs mn)	5,05,700	6,04,280	7,00,670	7,63,457	8,38,320
EBITDA (Rs mn)	1,14,400	1,39,690	1,65,576	1,94,173	2,13,210
Adj. net profit (Rs mn)	87,820	99,761	1,06,701	1,16,203	1,32,082
Adj. EPS (Rs)	31.5	36.7	39.3	42.8	48.7
Adj. EPS growth (%)	5.4	16.3	7.3	8.9	13.7
Adj. ROAE (%)	26.5	25.4	24.0	23.1	23.3
Adj. P/E (x)	19.0	16.3	15.2	14.0	12.3
EV/EBITDA (x)	14.2	11.6	9.7	8.1	7.0

Source: Company, BOBCAPS Research

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Key Q3 highlights

Integration of IBM product business progressing well

During Q3FY20, HCLT made steady progress on the integration of acquired IBM products –

- The company increased transactions three-fold QoQ to ~5,000 (including 700 new licence transactions), added 500 partners (taking the count to 1,800), and recorded 27 new AppScan and 23 new BigFix client wins in Q3.
- The quarter saw a milestone product release for Domino in Dec'19 together with 18 Domino client renewals.
- HCLT has transitioned over 4,600 customers to HCL Software and expects to onboard ~90% of acquired clients in another two quarters. The residual 10% of clients will transition as their multi-year deals come up for renewal.
- The company signed its first synergy deal win leveraging the services and software division (BigFix) to open a new logo.

Management has charted out plans to expand its service sales engine in geographies where it has HCL Software clients but lacks a service presence. Unlike IBM's erstwhile product guidance trends, HCLT has forecast a more distributed growth pattern across quarters for its software business, but will continue to evaluate the seasonality impact over eight quarters.

Demand commentary more upbeat than peers

HCLT's management indicated a sense of both pricing stability and normalisation of extreme price corrections/discounts on deal renewals. The Dec'19 quarter marked a healthy deal renewal period at the company, including successful renewals of all large-scale engagements.

Commentary on the BFSI vertical was also relatively optimistic. Management pointed to a stable-to-optimistic outlook, marked by a bottoming out of cost constraints in the capital market segment and healthy spends in retail banking.

FIG 1 – DEC'19 QUARTER PERFORMANCE

(Rs mn)	Q1FY19	Q2FY19	Q3FY19	Q4FY19	Q1FY20	Q2FY20	Q3FY20	YoY (%)	QoQ (%)	9MFY20	9MFY19	YoY (%)
Revenues (US\$ mn)	2,055	2,099	2,202	2,278	2,364	2,486	2,543	15.5	2.3	7,392	6,355	16.3
Revenue	1,38,780	1,48,610	1,56,990	1,59,900	1,64,250	1,75,280	1,81,350	15.5	3.5	5,20,880	4,44,380	17.2
Operating Expenditure	1,06,520	1,13,620	1,20,520	1,23,930	1,30,250	1,34,250	1,36,650	13.4	1.8	4,01,150	3,40,660	17.8
Cost of revenues	91,060	95,890	1,01,520	1,04,210	1,09,200	1,10,610	1,11,760	10.1	1.0	3,31,570	2,88,470	14.9
as % of sales	65.6	64.5	64.7	65.2	66.5	63.1	61.6	-	-	63.7	64.9	-
SG&A expenses	15,460	17,730	19,000	19,720	21,050	23,640	24,890	31.0	5.3	69,580	52,190	33.3
as % of sales	11.1	11.9	12.1	12.3	12.8	13.5	13.7	-	-	13.4	11.7	-
EBITDA	32,260	34,990	36,470	35,970	34,000	41,030	44,700	22.6	8.9	1,19,730	1,03,720	15.4
Depreciation	4,960	5,330	5,610	5,580	5,950	6,060	8,000	-	-	20,010	15,900	25.8
EBIT	27,300	29,660	30,860	30,390	28,050	34,970	36,700	18.9	4.9	99,720	87,820	13.6
Other Income	2,960	2,520	1,050	1,520	1,280	(30)	670	-	-	1,920	6,530	(70.6)
PBT	30,260	32,180	31,910	31,910	29,330	34,940	37,370	17.1	7.0	1,01,640	94,350	7.7
Total Tax	6,220	6,780	5,660	6,150	7,050	8,350	6,910	-	-	22,310	18,660	19.6
Adjusted PAT	24,040	25,400	26,250	25,760	22,280	26,590	30,460	16.0	14.6	79,330	75,690	4.8
(Profit)/loss from JV's/Ass/MI	0	0	(140)	0	(80)	(80)	(80)	-	-	(240)	(140)	-
APAT after MI	24,040	25,400	26,110	25,760	22,200	26,510	30,380	16.4	14.6	79,090	75,550	4.7
Extra ordinary items	0	0	0	0	0	0	0	-	-	0	0	-
Reported PAT	24,040	25,400	26,110	25,760	22,200	26,510	30,380	16.4	14.6	79,090	75,550	4.7
Reported EPS	8.6	9.1	9.6	9.5	8.2	9.8	11.2	16.7	14.6	29	27	6.7
Margins (%)								(bps)	(bps)			(bps)
EBITDA	23.2	23.5	23.2	22.5	20.7	23.4	24.6	140	120	23.0	23.3	(40)
EBIT	19.7	20.0	19.7	19.0	17.1	20.0	20.2	60	30	19.1	19.8	(60)
EBT	21.8	21.7	20.3	20.0	17.9	19.9	20.6	30	70	19.5	21.2	(170)
PAT	17.3	17.1	16.6	16.1	13.5	15.1	16.8	10	160	15.2	17.0	(180)
Effective Tax rate	20.6	21.1	17.7	19.3	24.0	23.9	18.5	80	(540)	22.0	19.8	220

Source: Company, BOBCAPS Research

FIG 2 – DEC'19 QUARTER OPERATING METRICS

Particulars (in US\$ terms)	Q3FY20 (% Contr. to Revenue)	Growth	
		QoQ (%)	YoY (%)
Revenue by Business Segment (%)			
Mode 1	66.0	0.8	7.5
Mode 2	18.2	1.8	22.9
Mode 3	15.8	10.0	53.4
Revenue by Geography (%)			
US	62.8	(0.2)	12.6
Europe	29.2	5.9	19.6
Asia Pacific	8	10.6	26.6
Revenue by Service Offering (%)			
IT and Business Services	70.2	0.6	9.6
Engineering and R&D Services	16.7	1.1	12.8
Products & Platforms	13.1	14.6	70.0
Revenue by Industry (%)			
BFSI	21.6	(1.3)	15.5

Particulars (in US\$ terms)	Q3FY20 (% Contr. to Revenue)	Growth	
		QoQ (%)	YoY (%)
Retail	10.3	5.4	16.6
Media, Publishing & Entertainment	9	9.6	13.0
Life Sciences	12.2	(3.2)	8.4
Energy Utilities - Public Sector	10.9	1.4	29.8
Manufacturing	20.9	8.0	36.4
Technology Services	15.1	0.3	(6.7)
Client Contribution to Revenue (%)			
Top 5	15.2	(0.3)	0.9
Top 10	22.4	(0.8)	4.3
Top 20	33	0.2	11.8

	Q3FY20	Q2F20	Q3FY19
Quarterly Annualised attrition rate (%)	25.5	28.1	26.9
Total Employees (nos)	1,49,173	1,47,123	1,32,328
Gross Addition (nos)	11,502	13,430	13,191
Net Addition (nos)	2,050	3,223	4,453
Revenues by Contract Type (%)			
Time & material	32.2	33.5	36.7
Fixed Price	67.8	66.5	63.3

Source: Company, BOBCAPS Research

Valuation methodology

HCLT is on a strong footing to close FY20 with the highest organic growth amongst tier-I IT services companies. Moreover, the relatively upbeat management commentary and annuity-based revenue profile of the software business lends confidence for near-to-medium-term revenue visibility.

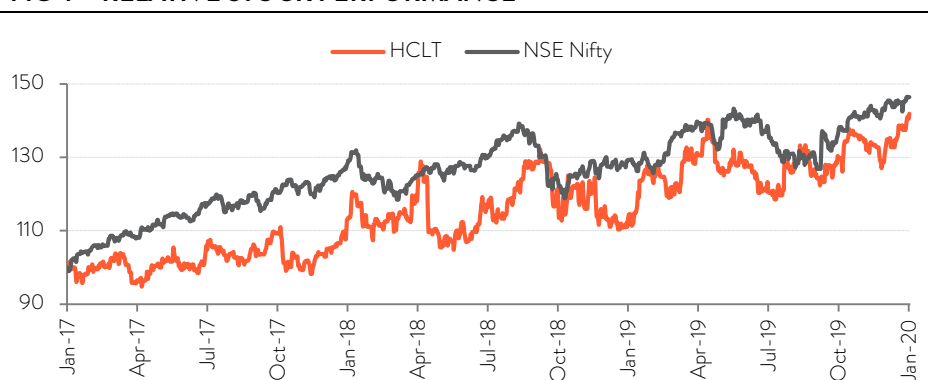
We raise FY21/FY22 EPS estimates by 3% each as we increase margin assumptions. On rollover, we have a new Mar'21 target price of Rs 690 (vs. Rs 630 earlier), based on an unchanged target P/E of 14.2x. Reiterate BUY.

FIG 3 – REVISED ESTIMATES

(Rs mn)	FY20E			FY21E			FY22E		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
Revenues (US\$ mn)	9,895	9,961	0.7	10,767	10,907	1.3	11,823	11,976	1.3
YoY growth (%)	14.6	15.4	-	8.8	9.5	-	9.8	9.8	-
Revenues	6,87,705	7,00,670	1.9	7,53,687	7,63,457	1.3	8,27,591	8,38,320	1.3
EBITDA	1,62,931	1,65,576	1.6	1,86,565	1,94,173	4.1	2,03,845	2,13,210	4.6
EBITDA margins (%)	23.7	23.6	-	24.8	25.4	-	24.6	25.4	-
EBIT margins (%)	18.8	19.2	-	18.5	19.3	-	18.8	19.6	-
Net profits	1,01,727	1,06,701	4.9	1,13,411	1,16,203	2.5	1,28,475	1,32,082	2.8
EPS (Rs)	37.5	39.3	4.9	41.8	42.8	2.5	47.3	48.7	2.8

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,
- higher-than-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)	FY18A	FY19A	FY20E	FY21E	FY22E
Total revenue	5,05,700	6,04,280	7,00,670	7,63,457	8,38,320
EBITDA	1,14,400	1,39,690	1,65,576	1,94,173	2,13,210
Depreciation	14,520	21,480	30,726	47,126	48,526
EBIT	99,880	1,18,210	1,34,851	1,47,048	1,64,685
Net interest income/(expenses)	0	(1,689)	0	0	0
Other income/(expenses)	11,110	8,050	2,804	3,865	6,850
Exceptional items	0	0	0	0	0
EBT	1,10,990	1,24,571	1,37,654	1,50,913	1,71,535
Income taxes	23,170	24,810	30,953	34,710	39,453
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	0	0	0	0	0
Reported net profit	87,820	99,761	1,06,701	1,16,203	1,32,082
Adjustments	0	0	0	0	0
Adjusted net profit	87,820	99,761	1,06,701	1,16,203	1,32,082

Balance Sheet

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Accounts payables	0	0	0	0	0
Other current liabilities	1,06,460	1,26,860	1,47,141	1,60,326	1,76,047
Provisions	5,300	0	14,013	15,269	16,766
Debt funds	4,370	39,860	39,860	39,860	39,860
Other liabilities	0	0	0	0	0
Equity capital	2,812	2,812	2,812	2,812	2,812
Reserves & surplus	3,65,348	4,14,888	4,70,244	5,30,531	5,99,055
Shareholders' fund	3,68,160	4,17,700	4,73,056	5,33,343	6,01,867
Total liabilities and equities	4,84,290	5,84,420	6,74,071	7,48,798	8,34,540
Cash and cash eq.	16,930	59,290	1,34,751	2,15,490	3,04,102
Accounts receivables	1,22,570	1,46,100	1,68,929	1,84,066	2,02,115
Inventories	0	0	0	0	0
Other current assets	25,190	37,160	45,544	49,625	54,491
Investments	86,040	58,520	58,520	58,520	58,520
Net fixed assets	1,18,646	1,32,396	1,19,257	89,631	58,605
CWIP	0	0	0	0	0
Intangible assets	77,244	1,02,564	1,02,564	1,02,564	1,02,564
Deferred tax assets, net	0	0	0	0	0
Other assets	37,670	52,930	49,047	53,442	58,682
Total assets	4,84,290	5,88,960	6,78,610	7,53,337	8,39,080

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY18A	FY19A	FY20E	FY21E	FY22E
Net income + Depreciation	1,00,510	1,20,740	1,37,427	1,63,329	1,80,608
Interest expenses	(4,450)	(4,480)	(2,804)	(3,865)	(6,850)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(12,340)	(24,660)	6,965	(9,173)	(10,937)
Other operating cash flows	(486)	(1,936)	0	0	0
Cash flow from operations	83,234	89,664	1,41,588	1,50,290	1,62,820
Capital expenditures	(53,210)	(34,340)	(17,586)	(17,500)	(17,500)
Change in investments	(13,180)	5,200	0	0	0
Other investing cash flows	44,016	(3,604)	2,804	3,865	6,850
Cash flow from investing	(22,374)	(32,744)	(14,782)	(13,635)	(10,650)
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	(1,480)	36,230	0	0	0
Interest expenses	(38,750)	(39,860)	0	0	0
Dividends paid	(16,910)	(10,990)	(51,344)	(55,917)	(63,558)
Other financing cash flows	0	0	0	0	0
Cash flow from financing	(57,140)	(14,620)	(51,344)	(55,917)	(63,558)
Changes in cash and cash eq.	3,720	42,300	75,461	80,739	88,613
Closing cash and cash eq.	16,930	59,290	1,34,751	2,15,490	3,04,102

Per Share

Y/E 31 Mar (Rs)	FY18A	FY19A	FY20E	FY21E	FY22E
Reported EPS	31.5	36.7	39.3	42.8	48.7
Adjusted EPS	31.5	36.7	39.3	42.8	48.7
Dividend per share	8.0	14.7	15.7	17.1	19.5
Book value per share	132.1	153.5	174.3	196.5	221.8

Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19A	FY20E	FY21E	FY22E
EV/Sales	3.2	2.7	2.3	2.1	1.8
EV/EBITDA	14.2	11.6	9.7	8.1	7.0
Adjusted P/E	19.0	16.3	15.2	14.0	12.3
P/BV	4.5	3.9	3.4	3.0	2.7

DuPont Analysis

Y/E 31 Mar (%)	FY18A	FY19A	FY20E	FY21E	FY22E
Tax burden (Net profit/PBT)	79.1	80.1	77.5	77.0	77.0
Interest burden (PBT/EBIT)	111.1	105.4	102.1	102.6	104.2
EBIT margin (EBIT/Revenue)	19.8	19.6	19.2	19.3	19.6
Asset turnover (Revenue/Avg TA)	106.6	112.6	110.6	106.6	105.3
Leverage (Avg TA/Avg Equity)	1.4	1.4	1.4	1.4	1.4
Adjusted ROAE	26.5	25.4	24.0	23.1	23.3

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

Ratio Analysis

Y/E 31 Mar	FY18A	FY19A	FY20E	FY21E	FY22E
YoY growth (%)					
Revenue	8.2	19.5	16.0	9.0	9.8
EBITDA	11.0	22.1	18.5	17.3	9.8
Adjusted EPS	5.4	16.3	7.3	8.9	13.7
Profitability & Return ratios (%)					
EBITDA margin	22.6	23.1	23.6	25.4	25.4
EBIT margin	19.8	19.6	19.2	19.3	19.6
Adjusted profit margin	17.4	16.5	15.2	15.2	15.8
Adjusted ROAE	26.5	25.4	24.0	23.1	23.3
ROCE	24.6	25.1	26.9	30.8	36.5
Working capital days (days)					
Receivables	83	81	82	84	84
Inventory	0	0	0	0	0
Payables	102	92	93	99	98
Ratios (x)					
Gross asset turnover	5.3	4.8	5.6	7.3	11.3
Current ratio	1.8	2.3	2.5	2.9	3.2
Net interest coverage ratio	NA	NA	NA	NA	NA
Adjusted debt/equity	0.0	0.0	(0.2)	(0.3)	(0.4)

Source: Company, BOBCAPS Research

Disclaimer

Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

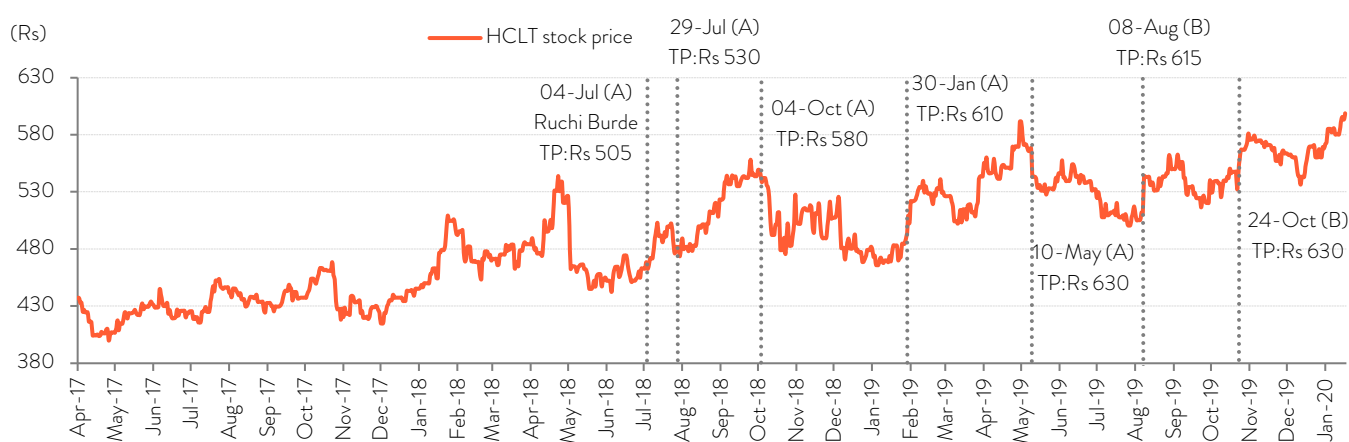
ADD – Expected return from >+5% to +15%

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: HCL TECHNOLOGIES (HCLT IN)



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

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