

HCL TECHNOLOGIES

IT - SERVICES

17 MAY 2017

Quarterly Update

HOLD

Target Price: Rs 902

Mode 1-2-3 powering growth and differentiation

Q4FY17 was marked by continued momentum in core verticals (BFSI, Manufacturing), 8 transformational deal wins, strong execution (utilization up 110bps QoQ) and seamless integration of acquisitions. **FY18 guidance encouraging:** Revenue growth of 10.5-12.5% in constant currency terms. Despite acquisitions, it has maintained EBIT margin guidance of 19.5-20.5% - a positive. Thus, even in FY18, HCLT should outperform peers.

Multi-mode (Mode 1-2-3) strategy is enabling deeper penetration, market share gains and driving differentiated IP/platform offerings. Management expects Mode 2-3 strategy to contribute ~35% of portfolio by FY21 (FY17: ~19%). BFSI remains a growth vertical and HCLT has been a beneficiary of vendor consolidation activity and increasing digital spends.

CMP : Rs 839
Potential Upside : 8%

MARKET DATA

No. of Shares : 1,427 mn
Free Float : 40%
Market Cap : Rs 1,197 bn
52-week High / Low : Rs 890 / Rs 707
Avg. Daily vol. (6mth) : 1.6 mn shares
Bloomberg Code : HCLT IB Equity
Promoters Holding : 60%
FII / DII : 25% / 8%

Multi-mode strategy to leverage changing industry dynamics and accelerate IP/platform presence

- ♦ **Mode 1 (FY17 share: 81.4%, up 8.3% YoY):** comprises core services of Applications, IMS, BPO and Engg & R&D. HCLT leverages its DRYICE Autonomics to transform clients' business and IT landscape. In addition to large deal wins, HCL entered into an agreement to acquire 100% stake in Urban Fulfillment Services, LLC, a provider of mortgage business process & fulfillment services. This acquisition adds 350+ highly skilled professionals. HCLT also completed the acquisition of Geometric, strengthening its position in the space of Industry 4.0, Industrial IoT and Digital Manufacturing
- ♦ **Mode 2 (FY17: 12.8% of rev, up 16.4% YoY):** involves delivering experience-centric and outcome-oriented integrated offerings of Digital & Analytics, IoTWORKS, Cloud Native Services and Cyber security & GRC services. HCLT continues to enhance its partnerships (Azure, AWS, Blue Mix, Mulesoft, Adobe, Metosphere etc), enhancing its framework etc. 62% of its Top 150 clients have been penetrated under Mode 2 services. HCLT sees very little impact due to shift from legacy to digital services. IoT WORKS is seeing good traction in the market with 6 new logos being added and is helping in tapping new buyers

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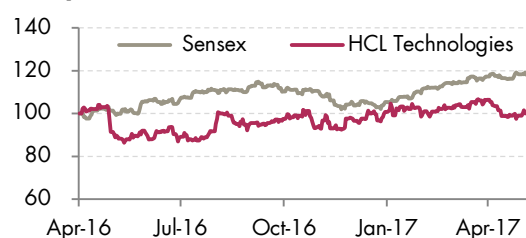
Financial summary (Consolidated)

Y/E June	FY16	FY17	FY18E	FY19E
Sales (Rs bn)	311	467	519	589
Adj PAT (Rs bn)	56	85	92	106
Con. EPS* (Rs)	-	-	63	68
EPS (Rs)	53	60	65	75
Change YOY (%)	2	52	8	16
P/E (x)	21	14	13	11
RoE (%)	21	27	26	26
RoCE (%)	25	31	31	32
EV/E (x)	16	10	9	7
DPS (Rs)	17	24	28	32

Key drivers

(USD bn)	FY17	FY18E	FY19E
USD revenue	7.0	7.7	8.6
% change YoY	12%	11%	11%
EBIT margin	20.3%	20.5%	21.2%

Price performance



Source: *Consensus broker estimates, Company, Axis Capital

Note: FY16 is for 9 months due to year end change from June to March. Hence, revenue, EBITDA, RoE, RoCE not comparable. We have annualized 9MFY16 EPS for comparison of YoY growth rates

Exhibit 1: Results update (Rs mn)

	Quarter ended					12 months ended		
	Mar-17	Mar-16	% Chg	Dec-16	% Chg	Mar-18E	Mar-17	% Chg
Revenue (USD terms)	1,817	1,587	14.5	1,745	4.1	7,744	6,975	11.0
Net sales	120,530	106,980	12.7	118,140	2.0	518,818	467,220	11.0
EBITDA	26,490	23,790	11.3	26,280	0.8	115,923	103,090	12.4
Other income	2,150	2,000	-	2,310		9,105	9,340	-
PBIDT	28,640	25,790	11.1	28,590	0.2	125,028	112,430	11.2
Depreciation	2,330	1,570	-	2,200	-	9,690	8,340	-
PBT	26,310	24,220	-	26,390	-	115,338	104,090	-
Tax	3,030	4,970	-	5,680	-	23,644	19,520	-
Adjusted PAT	23,280	19,250	20.9	20,710	12.4	91,693	84,570	8.4
No. of shares (mn)	1,413	1,413	-	1,413	-	1,413	1,412	-
EBIDTA margin (%)	22.0	22.2	(26)bps	22.2	(27)bps	22.3	22.1	28 bps
PBIDT margin (%)	23.8	24.1	(35)bps	24.2	(44)bps	24.1	24.1	3 bps
EPS (Rs.)	16.5	13.6	20.9	14.7	12.4	64.9	59.9	8.4

Source: Company, Axis Capital

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- ♦ **Mode 3 (FY17: 5.8% of rev, up 80.2% YoY):** HCL continues to explore & enter into strategic and innovative IP-based partnerships, targeting specific next-generation opportunities. In Q4FY17, HCLT extended its IP partnership with IBM for additional products in the areas of Information Management and Database Management Systems. HCLT has committed to invest ~USD 80 mn in the extended partnership. It also continues to invest in internal IP creation strategy and expand the capabilities and markets for DRYICE. Management shared every component/ sub-segment of DRYICE is in itself a growth component; thus presents a promising future

FY18 guidance

- ♦ FY18 guidance (revenue growth of 10.5-12.5% in constant currency terms). Based on 31 March 2017 exchange rate, this would imply revenue growth of 9.9% to 11.9% in USD terms
- ♦ EBIT margin guidance maintained at 19.5% to 20.5% (assumed USD / INR at Rs 65.5 and other currencies at FY17 average exchange rates)

Key highlights: Q4FY17 and management concall

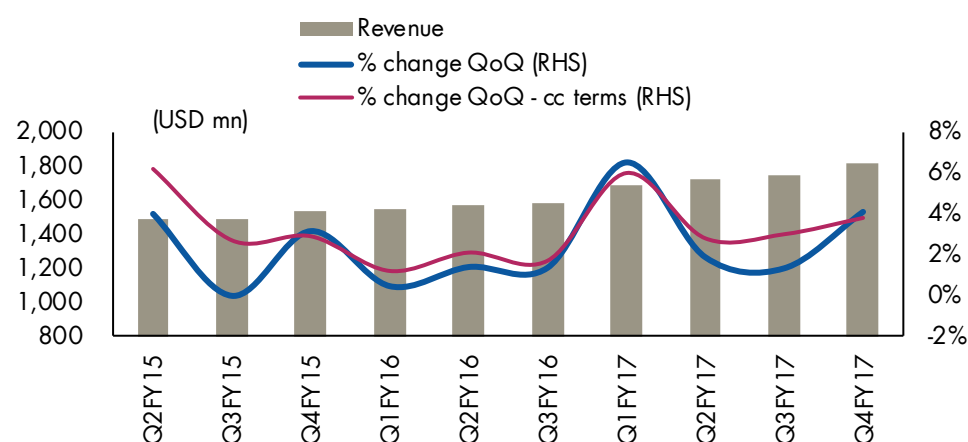
- ♦ **Update on Financial services (~24% share):** Management shared it remains a dominant player in the Capital Market segment. In this sub-segment, clients are spending on cost rationalization and next-gen services. In Banking and Insurance, growth is seen in digital, analytics and security. HCLT sees strong opportunity in cross selling within existing clients. New account wins are being driven by its ability to provide higher quality work in data, digital and analytics. Overall budgets are flat to 2% increase and vendor consolidation activity is presenting good growth opportunity. The mix is changing from traditional spends towards digital

- ◆ **IMS (~39% share):** Rebid market remains promising and Europe remains a high growth market especially in Nordics, Continental Europe etc. Expects growth momentum in cloud related migration
- ◆ Constant currency revenue of USD ~1,811mn, up 3.8% QoQ (Infosys: flat, TCS: 1%). In USD terms, revenue was USD 1,817 mn; up ~4% QoQ
- ◆ Revenue from Mode 1 at 81.4% (up 8.3% YoY), Mode 2 at 12.8% (up 16.4% YoY) and Mode 3 at 5.8% (up 80.2% YoY).
- ◆ **Momentum in deal signing continues:** 8 transformation deals signed in Q4FY17 across service lines and verticals
- ◆ **In constant currency terms,** In cc terms, revenue recorded a growth of 3.8% QoQ. Growth was led by Engg. and R&D (14.6% QoQ; ~21% share) Infrastructure services (~0.9% QoQ; ~39% share) and Applications services (~1.8% QoQ; ~37% of share)
- ◆ **Blended utilization** at 85.7% (Q3FY17: 84.6%), Attrition (IT Services) down 100 bps at 16.9% (Q3:17.9%)
- ◆ **Client mining:** 1 client added in USD 50 client bucket
- ◆ **Vertical performance:** Financial Services (up ~3.0%, ~24% of revenue), Manufacturing up ~6.3% QoQ (~35% of revenue), Public services up ~8.1% (~12% of revenue) with Lifesciences& Healthcare flat (~12% of revenue), Retail/CPG up 2.1% (~9% of revenue)
- ◆ SG&A jumped during the quarter due to acquisition related expenses

Valuation

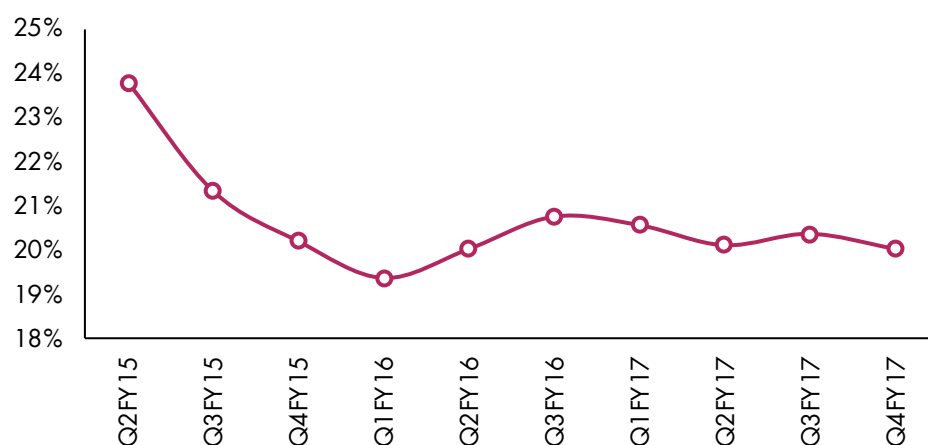
We expect USD revenue CAGR of 11% over FY17-19E. In INR terms, our CAGR stands at 12% for revenue, 14% for EBIT and 12% for PAT with an EPS of Rs65/ Rs 75 for FY18E/FY19E. We rollover our target price to FY19E and value the company at Rs 902 (12x FY19E). **Maintain HOLD** given 8% upside from CMP of Rs 839. The stock trades at 13x/11x FY18E/19E EPS.

Exhibit 2: Revenue growth (cc)



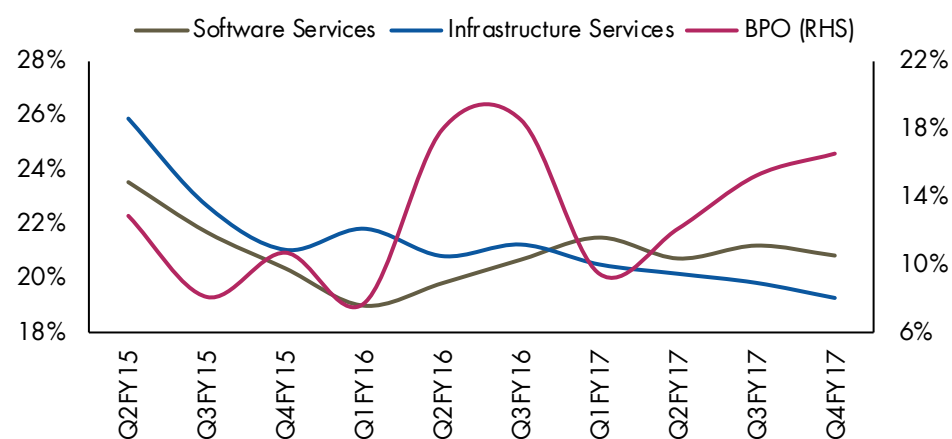
Source: Company, Axis Capital

Exhibit 3: EBIT margin



Source: Company, Axis Capital

Exhibit 4: Segment margins



Source: Company, Axis Capital

Exhibit 5: Client mining

	Q2FY15	Q3FY15	Q4FY15	Q1FY16	Q2FY16	Q3FY16	Q1FY17	Q2FY17	Q3FY17	Q4FY17
No. of Million \$ Clients	450	468	476	486	494	482	482	494	496	506
No. of 5 Million \$ Clients	205	206	211	224	227	233	237	235	241	246
No. of 10 Million \$ Clients	121	122	124	133	140	144	146	146	148	153
No. of 20 Million \$ Clients	69	73	73	75	74	75	80	82	87	85
No. of 30 Million \$ Clients	37	38	40	43	42	43	48	49	48	49
No. of 40 Million \$ Clients	22	22	23	24	26	29	32	34	35	34
No. of 50 Million \$ Clients	16	17	17	18	19	19	20	20	24	25
No : of 100 Million \$ Clients	7	7	7	7	7	8	7	8	8	8

Source: Company, Axis Capital

Exhibit 6: Performance in Top clients

	Q2FY15	Q3FY15	Q4FY15	Q1FY16	Q2FY16	Q3FY16	Q1FY17	Q2FY17	Q3FY17	Q4FY17
Rev. (USD mn)	1,491	1,491	1,538	1,545	1,566	1,587	1,691	1,722	1,745	1,817
Rev. share (%)										
Top 5 clients	14.0	13.5	13.2	13.6	13.6	13.6	13.9	13.8	14.2	14.7
Top 10 clients	22.3	21.8	21.7	21.9	21.7	21.8	21.8	21.6	21.7	22.1
Top 20 clients	32.4	32.2	32.4	32.4	32.4	32.2	31.7	31.8	31.9	32.9
Remaining clients	67.6	67.8	67.6	67.6	67.6	67.8	68.3	68.2	68.1	67.1
Rev. share (USD mn)										
Top 5 clients	209	201	203	210	213	216	235	238	248	267
Top 6-10 clients	124	124	131	128	127	130	134	134	131	134
Top 11-20 clients	151	155	165	162	168	165	167	176	178	196
Remaining clients	1008	1011	1039	1044	1059	1076	1155	1175	1189	1219
Rev. share (% change QoQ)										
Top 5 clients	1.1%	-3.6%	0.9%	3.5%	1.4%	1.4%	8.9%	1.1%	4.3%	7.8%
Top 6-10 clients	-0.8%	0.0%	5.6%	-1.9%	-1.1%	2.6%	2.6%	0.6%	-2.6%	2.7%
Top 11-20 clients	6.1%	2.9%	6.1%	-1.4%	3.3%	-1.5%	1.4%	5.0%	1.3%	10.2%
Remaining clients	4.9%	0.3%	2.8%	0.5%	1.4%	1.7%	7.3%	1.7%	1.2%	2.6%

Source: Company, Axis Capital

Exhibit 7: Vertical performance

	Q1FY16 Sept'2015	Q2FY16 Dec'15	Q3FY16 March'2016	Q1FY17 June 2016	Q2FY17	Q3FY17	Q4FY17
Revenue share %							
Financial Services	26.1	25.9	25.0	23.6	24.1	24.3	24.2
Manufacturing	32.5	31.5	31.4	33.2	32.2	33.9	34.6
Life Sciences & Healthcare	12.4	12.2	12.8	11.9	12.6	12.0	11.5
Public Services	10.0	10.6	11.1	11.7	10.9	11.2	11.7
Retail & CPG	8.8	9.5	9.2	10.0	10.4	9.4	9.2
Telecom, Media, Publishing & Entertainment	9.6	9.7	9.9	9.1	9.4	8.9	8.4
Others	0.6	0.6	0.5	0.5	0.4	0.4	0.3
% change QoQ in cc terms							
Financial Services	1.9%	1.9%	-1.3%	-0.1%	5.6%	4.5%	3.0%
Manufacturing	0.5%	-1.3%	0.9%	12.0%	-0.9%	8.3%	6.3%
Life Sciences & Healthcare	4.3%	0.3%	6.4%	-1.0%	8.2%	-2.9%	0.1%
Public Services	4.9%	8.4%	7.1%	11.8%	-3.7%	5.6%	8.1%
Retail & CPG	1.4%	10.3%	-1.2%	14.5%	7.7%	-6.9%	2.1%
Telecom, Media, Publishing & Entertainment	1.0%	3.4%	4.2%	-2.8%	6.1%	-3.3%	-2.1%

Source: Company, Axis Capital

Exhibit 8: Services performance

	Q1FY16 Sept'2015	Q2FY16 Dec'15	Q3FY16 March'2016	Q1FY17 June 2016	Q2FY17	Q3FY17	Q4FY17
Revenue share %							
Engineering and R&D Services	19.2	18.6	18.7	17.7	17.8	18.6	20.5
Custom Application (Industry Solutions) + Enterprise Apps	40.4	40.4	39.9	38.3	37.8	37.5	36.8
Infrastructure Services	35.1	35.5	36.2	39.8	40.3	39.8	38.8
BPO Services	5.3	5.5	5.2	4.1	4.1	4.0	3.9
% change QoQ in cc terms							
Engineering and R&D Services	3.6%	-1.5%	1.9%	0.7%	2.3%	7.1%	14.6%
Custom Application (Industry Solutions) + Enterprise Apps	0.1%	2.0%	0.5%	1.9%	1.4%	2.0%	1.8%
Infrastructure Services	0.9%	3.4%	3.9%	16.5%	4.4%	2.1%	0.9%
BPO Services	2.4%	8.0%	-4.1%	-15.9%	2.1%	2.9%	0.2%

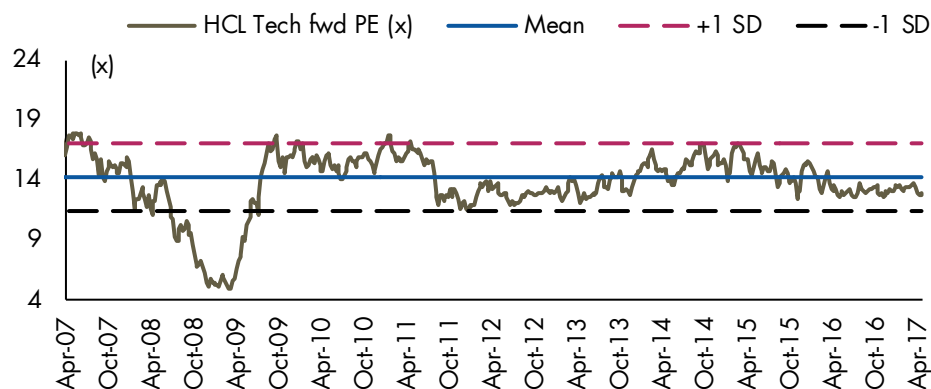
Source: Company, Axis Capital

Exhibit 9: Geography performance

	Q1FY16 Sept'2015	Q2FY16 Dec'15	Q3FY16 March'2016	Q1FY17 June 2016	Q2FY17	Q3FY17	Q4FY17
Revenue share %							
US	58.7	61.0	62.5	59.9	61.9	61.9	62.6
Europe	31.7	29.9	28.4	31.4	29.3	29.6	27.7
ROW	9.6	9.1	9.1	8.7	8.8	8.5	9.7
% change QoQ in cc terms							
US	0.7%	5.5%	3.7%	2.0%	5.5%	1.7%	5.3%
Europe	5.6%	-2.4%	-2.4%	16.9%	-2.1%	6.8%	-3.0%
RoW	-8.4%	-3.4%	1.3%	0.0%	2.0%	-0.5%	15.8%

Source: Company, Axis Capital

Exhibit 10: P/E valuation



Source: Bloomberg, Axis Capital

Financial summary (Consolidated)

Profit & loss (Rs bn)

Y/E June	FY16	FY17	FY18E	FY19E
Net sales	311	467	519	589
Other operating income	-	-	-	-
Total operating income	311	467	519	589
Cost of goods sold	(205)	(309)	(336)	(378)
Gross profit	107	158	183	211
<i>Gross margin (%)</i>	<i>34</i>	<i>34</i>	<i>35</i>	<i>36</i>
Total operating expenses	(40)	(55)	(67)	(75)
EBITDA	67	103	116	136
<i>EBITDA margin (%)</i>	<i>22</i>	<i>22</i>	<i>22</i>	<i>23</i>
Depreciation	(4)	(8)	(10)	(11)
EBIT	63	95	106	125
Net interest	-	-	-	-
Other income	8	7	9	11
Profit before tax	70	104	115	135
Total taxation	(15)	(20)	(24)	(29)
<i>Tax rate (%)</i>	<i>21</i>	<i>19</i>	<i>21</i>	<i>22</i>
Profit after tax	56	85	92	106
Minorities	-	-	-	-
Profit/ Loss associate co(s)	-	-	-	-
Adjusted net profit	56	85	92	106
<i>Adj. PAT margin (%)</i>	<i>18</i>	<i>18</i>	<i>18</i>	<i>18</i>
Net non-recurring items	-	-	-	-
Reported net profit	56	85	92	106

Balance sheet (Rs bn)

Y/E June	FY16	FY17	FY18E	FY19E
Paid-up capital	3	3	3	3
Reserves & surplus	277	332	378	431
Net worth	280	335	380	434
Borrowing	10	5	5	5
Other non-current liabilities	13	13	14	15
Total liabilities	303	353	399	454
Total fixed assets	43	87	98	108
Other Investment	2	1	1	1
Debtors	107	108	121	137
Cash & bank	113	115	157	193
Loans & advances	-	-	-	-
Current liabilities	95	111	137	154
Net current assets	149	142	171	210
Other non-current assets	103	111	118	122
Total assets	303	353	399	454

Cash flow (Rs bn)

Y/E June	FY16	FY17	FY18E	FY19E
Profit before tax	70	104	115	135
Depreciation & Amortisation	4	8	10	11
<i>Chg in working capital</i>	<i>(10)</i>	<i>10</i>	<i>13</i>	<i>(4)</i>
Cash flow from operations	50	103	114	113
<i>Capital expenditure</i>	<i>(9)</i>	<i>(53)</i>	<i>(20)</i>	<i>(21)</i>
Cash flow from investing	(29)	(66)	(26)	(25)
<i>Equity raised/ (repaid)</i>	<i>1</i>	<i>-</i>	<i>-</i>	<i>-</i>
<i>Debt raised/ (repaid)</i>	<i>5</i>	<i>(4)</i>	<i>-</i>	<i>-</i>
<i>Dividend paid</i>	<i>(29)</i>	<i>(41)</i>	<i>(48)</i>	<i>(54)</i>
Cash flow from financing	(22)	(45)	(48)	(54)
Net chg in cash	(1)	(9)	40	34

Key ratios

Y/E June	FY16	FY17	FY18E	FY19E
OPERATIONAL				
FDEPS (Rs)	53	60	65	75
CEPS (Rs)	43	66	72	83
DPS (Rs)	17	24	28	32
Dividend payout ratio (%)	44	40	43	43
GROWTH				
Net sales (%)	-	50	11	13
EBITDA (%)	-	54	12	17
Adj net profit (%)	2.4	52	8	16
FDEPS (%)	2.4	52	8	16
PERFORMANCE				
RoE (%)	21.1	27.5	25.6	26.1
RoCE (%)	24.7	31.2	30.7	31.7
EFFICIENCY				
Asset turnover (x)	2.0	2.4	2.4	2.6
Sales/ total assets (x)	0.8	1.1	1.0	1.0
Receivable days	126	84	85	85
Payable days	142	112	124	124
FINANCIAL STABILITY				
Current ratio (x)	2.6	2.3	2.2	2.4

VALUATION

PE (x)	21.3	14.0	12.9	11.2
EV/ EBITDA (x)	16.1	10.3	8.8	7.3
EV/ Net sales (x)	3.5	2.3	2.0	1.7
PB (x)	4.2	3.5	3.1	2.7
Dividend yield (%)	2.1	2.9	3.3	3.8

Source: Company, Axis Capital; Note: FY16 is for 9 months due to year end change from June to March. Hence Revenue, EBITDA, RoE, RoCE not comparable. We have annualized 9mFY16 EPS for comparison of YoY growth rates.

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Ratings	Expected absolute returns over 12-18 months
BUY	More than 10%
HOLD	Between 10% and -10%
SELL	Less than -10%

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