

HCL TECHNOLOGIES

Margin guidance reinforces confidence

India Equity Research | IT

HCL Technologies' (HCLT) Q4FY17 revenue at USD1,817mn jumped 4.1% QoQ (3.8% in CC terms) versus Street's 3.1% growth estimate. EBITDA margin at 22.0% came in line with Street's estimate. Management has guided for 10.5-12.5% CC revenue growth and 19.5-20.5% operating margin in FY18. Management stated that Mode 2 & 3 and outcome oriented & ecosystem driven offerings are gaining good traction—grew a healthy 16.4% and 80.2% in FY17, respectively. We maintain our thesis that with a significant portion of the portfolio geared towards IMS, ER&D and digital, HCLT is poised to report modest revenue growth. Maintain 'BUY' with INR1,058 target price.

Inorganic revenue aids growth

HCLT's 3.8% CC growth was driven by 14.6% QoQ CC surge in ER&D, led by inorganic revenue from Geometric and Butler Aerospace; application and infrastructure services grew 1.8% and 0.9% QoQ (CC), respectively. We expect the revenue growth momentum to sustain on account of the company's strong portfolio, significant opportunities in the IMS renewal market and inorganic revenue contribution. Operating margin tumbled 40bps QoQ to 20.0% due to lower gross margin and higher SG&A expenses.

Margin guidance maintained despite headwinds

The company has guided for 10.5-12.5% CC revenue growth in FY18, which translates into 9.9-11.9% USD growth based on March 31, 2017 rates. HCLT has maintained 19.5-20.5% operating margin at exchange rate of INR65.5 versus INR66.3 in FY17 despite ongoing investments in Mode 2 & 3 offerings. The company's margin guidance, despite INR appreciation and investments, highlights management's focus on gunning for profitable growth.

Outlook and valuations: Thesis intact; maintain 'BUY'

We believe, HCLT has managed margin well despite acquisitions and investments in Mode 2 & 3 offerings. This bolsters our confidence in the company's earnings prospects, even if revenue growth remains subdued. Despite strong portfolio and margin comfort, the stock is trading at reasonable valuation (11.9x FY19E EPS). We maintain our estimates and 'BUY/SP' with target price of INR1,058 (15x FY19E EPS).

EDELWEISS 4D RATINGS

Absolute Rating	BUY
Rating Relative to Sector	Performer
Risk Rating Relative to Sector	High
Sector Relative to Market	Overweight

MARKET DATA (R: HCLT.BO, B: HCLT IN)

CMP	: INR 839
Target Price	: INR 1,058
52-week range (INR)	: 890 / 706
Share in issue (mn)	: 1,427.1
M cap (INR bn/USD mn)	: 1,197 / 18,593
Avg. Daily Vol.BSE/NSE('000)	: 1,979.0

SHARE HOLDING PATTERN (%)

	Current	Q2FY17	Q1FY17
Promoters *	59.7	60.3	60.4
MF's, FI's & BK's	7.7	8.0	6.7
FII's	24.6	24.3	25.7
Others	8.0	7.4	7.2
* Promoters pledged shares (% of share in issue)	:	NIL	

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Technology Index
1 month	0.6	2.0	(1.5)
3 months	1.2	7.2	(1.6)
12 months	18.3	20.0	(11.2)

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Financials

(INR mn)

Year to March	Q4FY17	Q3FY17	% Chg	Q4FY16	% Chg	FY17	FY18E	FY19E
Net revenues	120,530	118,140	2.0	106,980	12.7	467,220	523,514	577,075
EBITDA	26,490	26,280	0.8	23,790	11.3	103,090	114,753	127,363
Adjusted Profit	23,280	20,710	12.4	19,250	20.9	84,570	90,406	99,823
Diluted EPS (INR)	16.5	14.7	12.2	13.6	20.8	59.9	64.0	70.6
Diluted P/E (x)						14.0	13.1	11.9
EV/EBITDA (x)						11.4	10.0	8.6
EV/Revenues (x)						2.5	2.2	1.9

Recalibrating business towards product strategy

HCLT, under the new CEO Mr. C. Vijaykumar, has recalibrated its future strategy—to pursue product business. Accordingly, the company has devised Mode 1-2-3 strategy. Under Mode 1 (Core Services), HCLT delivers core services in applications, infrastructure, BPO and ER&D, leveraging automation platform to transform clients' business and IT landscape. These services now contribute 81.4% to revenue and grew 8.3% in FY17. Under Mode 2 (Next Generation Services), HCLT delivers experience-centric and outcome-oriented integrated offerings of digital & analytics, IoT, cloud and Cybersecurity services. These services now contribute 12.8% to revenue and grew 16.4% in FY17. In Mode 3 (Products and Platforms) HCLT explores & enters into strategic and innovative IP-based partnerships, targeting specific next-generation opportunities. These services now contribute 5.8% to revenue and grew a staggering 80.2% in FY17.

Table 1: Proportion of Mode 1-2-3 revenues

Revenue mix (%)	FY16	FY17	YoY growth (%)
Mode 1	84.1	81.4	8.3
Mode 2	12.3	12.8	16.4
Mode 3	3.6	5.8	80.2

Source: Company

Acquisitions to enhance portfolio depth

HCLT has invested heavily in acquiring capabilities to enhance its Mode 2 and 3 offerings. The company is focused on staying relevant in next generation high growth services and is eyeing inorganic opportunities to gain skill sets, if required. In order to further strengthen its ER&D prowess, it has acquired Butler America (provides engineering and design services to aerospace and defence customers) and Geometric (specialist in engineering services). While Butler America clocked revenue of ~USD85mn in CY15, Geometric's expected annualised revenue is pegged at ~USD140mn. HCLT has also acquired Volvo's external IT services business, which is expected to generate annualised revenue of ~USD160mn. In Q4FY17, the company has invested further ~USD80mn in IBM's product and platforms, taking total investment therein to ~USD633mn, which is expected to generate annualised revenue in the USD160-200mn range.

Outlook and valuations: Thesis intact; maintain 'BUY'

Despite acquisitions, HCLT has done a commendable job of maintaining margin at the upper band of the guided 19.5-20.5%. We continue to maintain our thesis that IMS, ER&D and digital are key growth drivers for IT services from bottom-up model. With the company's focus on acquisitions to strengthen its services portfolio along with commendable execution to maintain margin, we believe the stock is trading at reasonable valuation—11.9x FY19E EPS. We maintain 'BUY/SP' with target price of INR1,058 (15.0x FY19E EPS).

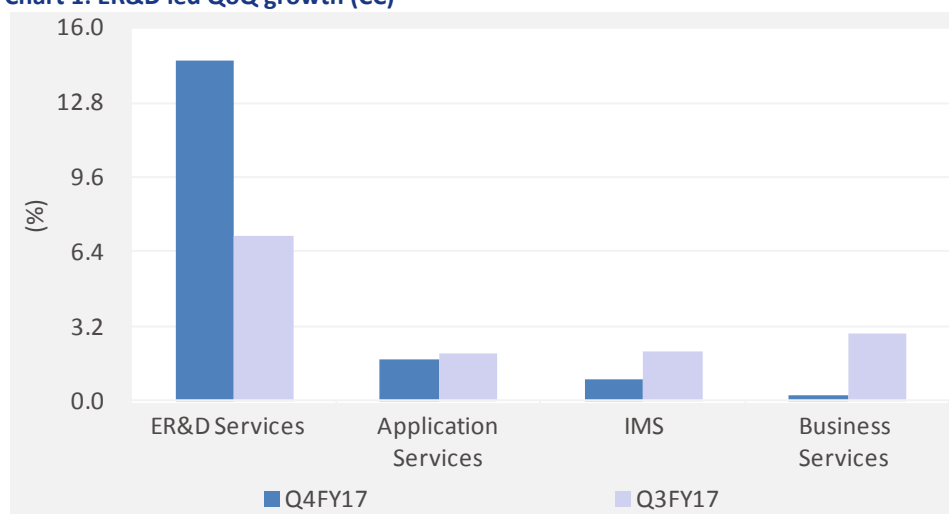
Q4FY17: Key highlights

- Consolidated revenue at USD1,817mn, up 4.1% QoQ, was above Street's 3.1% QoQ estimate. In CC, revenue grew 3.8% QoQ. In INR, revenue at INR120.5bn rose 2.0% QoQ and 12.7% YoY.
- Gross profit stood at INR40.7bn, up 1.5% QoQ and 8.8% YoY. Gross margin, at 33.7%, fell 20bps QoQ. EBITDA stood at INR26.5bn with EBITDA margin at 22.0% (down 20bps QoQ).
- Net profit jumped 12.4% QoQ and 20.9% YoY to INR23.3bn, majorly on account of lower tax provision for the quarter.
- Net employees increased by 4,881, taking total employee count to 115,973. Gross addition for the quarter was 10,605.

Segmental performance

- IT services:** The segment (contributes ~96% to total revenue) grew 16.0% YoY (4.2% QoQ) to USD1,746mn versus USD1,675mn in previous quarter. Operating margin (EBIT) declined 40bps QoQ to 20.2%.
 - Core software:** Revenue, at USD1041mn, grew 6.2% QoQ and 11.9% YoY. Operating margin (EBIT), at 20.8%, dipped 40bps QoQ.
 - IMS:** Revenue at USD705.1mn increased 1.5% QoQ. EBIT margin fell 60bps QoQ to 19.2%.
- BPO:** Revenue, at USD71.0mn, rose 0.5% QoQ and tumbled 14.1% YoY. EBIT margin jumped 130bps QoQ to 16.5%.
- Services:** Revenue growth was broad based across services, i.e., Engineering and R&D (up 14.6% QoQ CC), Application Services (up 1.8% QoQ CC), IMS (up 0.9% QoQ CC) and Business Services (up 0.2% QoQ CC).

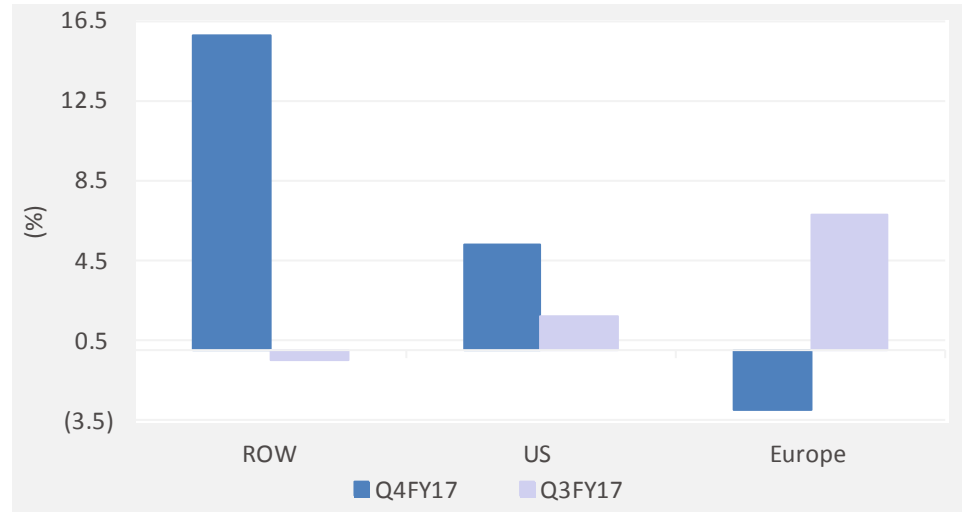
Chart 1: ER&D led QoQ growth (CC)



Source: Company, Edelweiss research

- **Geo split:** In CC terms, growth was led by RoW (up 15.8% QoQ) and Americas (up 5.3% QoQ), while Europe declined 3.0% QoQ.

Chart 2: US powered growth during quarter (CC)



Source: Company, Edelweiss research

- Public Services, Manufacturing, Financial Services and Retail & CPG grew 8.1%, 6.3%, 3.0% and 2.1% QoQ, respectively, in CC terms. While Lifesciences & Healthcare was flat QoQ (CC), Telecommunications, Media, Publishing & Entertainment declined 2.1% QoQ in CC.
- **Client addition:** Number of clients contributing USD1mn and USD5mn plus stood at 506 (10 additions QoQ) and 246 (5 additions QoQ), respectively. Number of clients in the USD10mn plus category (153) increased by 5 QoQ. HCLT lost 2 clients in the USD20mn plus category (85 clients) and added 1 client in the USD30mn plus category (49 clients). Number of USD40mn plus clients reduced by 1 to 34 and USD50mn increased by 1 QoQ to 25, while the number of USD100mn plus clients remained flat at 8.
- **Attrition** in IT services (LTM) stood at 16.9% versus 17.9% in the previous quarter.
- **Utilisation:** Blended utilisation rose 110bps QoQ to 85.7%.
- DSO stood at 63 days, up 2 days QoQ.

Financial snapshot

(INR mn)

Year to March	Q4FY17	Q3FY17	% Change	Q4FY16	% Change	FY17	FY18E	FY19E
Net revenues	120,530	118,140	2.0	106,980	12.7	467,220	523,514	577,075
Direct costs	79,870	78,090	2.3	69,610	14.7	308,890	345,940	382,056
Gross profit	40,660	40,050	1.5	37,370	8.8	158,330	177,574	195,019
SG&A	14,170	13,770	2.9	13,580	4.3	55,240	62,822	67,656
EBITDA	26,490	26,280	0.8	23,790	11.3	103,090	114,753	127,363
Depreciation	2,330	2,200	5.9	1,570	48.4	8,340	8,651	9,233
EBIT	24,160	24,080	0.3	22,220	8.7	94,750	106,102	118,129
Other income	1,670	1,880	(11.2)	1,970	(15.2)	7,460	8,515	9,546
Foreign exc. gain / (loss)	480	430	11.6	30	1,500.0	1,880	1,288	303
Profit before tax	26,310	26,390	(0.3)	24,220	8.6	104,090	115,906	127,978
Provision for taxes	3,030	5,680	(46.7)	4,970	(39.0)	19,520	25,499	28,155
Reported net profit	23,280	20,710	12.4	19,250	20.9	84,570	90,406	99,823
Adjusted Profit	23,280	20,710	12.4	19,250	20.9	84,570	90,406	99,823
Diluted EPS (INR)	16.5	14.7	12.2	13.6	20.8	59.9	64.0	70.6
Diluted P/E (x)	-	-	-	-	-	14.0	13.1	11.9
EV/EBITDA (x)	-	-	-	-	-	11.4	10.0	8.6
EV/Revenues (x)	-	-	-	-	-	2.5	2.2	1.9
Tax Rate	11.5	21.5	-	20.5	-	18.8	22.0	22.0

As % of net revenues

Gross profit	33.7	33.9	-	34.9	-	33.9	33.9	33.8
SG&A	11.8	11.7	-	12.7	-	11.8	12.0	11.7
EBITDA	22.0	22.2	-	22.2	-	22.1	21.9	22.1
EBIT	20.0	20.4	-	20.8	-	20.3	20.3	20.5
Reported net profit	19.3	17.5	-	18.0	-	18.1	17.3	17.3

Company Description

HCLT is India's fourth-largest IT services company. It provides software-led IT solutions, remote infrastructure management, and BPO services, focused mainly on transformational outsourcing. The company leverages its extensive offshore infrastructure and global network of offices in 26 countries to deliver solutions across select verticals, including financial services, retail and consumer, life sciences aerospace, automotive, semiconductors, telecom and media publishing, and entertainment. The company's employee force stands at 115,973 and its revenues for the past twelve months stood at INR467.2bn (USD7.0bn).

Investment Theme

As a scale player HCLT is expected to gradually increase its share of the total IT pie largely through its rapidly growing infrastructure management practice and robust order book. HCLT has been aggressively pursuing large deals in the past few quarters. Its well-established infrastructure management practice, combined with its EAS practice, provides significant cross-selling opportunity, which could help HCLT win some of the large size deals. The ramp up of the deals over the next two years will drive the revenue growth for the company.

Key Risks

Key risks to our investment theme include: (a) sustained slowdown in the US; (b) failure in maintaining margins at current levels, while pursuing large deals; (c) higher wage inflation and other costs resulting in significant margin dilution and (d) appreciation of the INR against the USD, EUR and GBP.

Financial Statements

Key Assumptions

Year to March	FY16	FY17	FY18E	FY19E
Macro				
GDP(Y-o-Y %)	7.2	6.5	7.1	7.7
Inflation (Avg)	4.9	4.8	5.0	5.2
Repo rate (exit rate)	6.8	6.0	6.3	6.3
USD/INR (Avg)	65.0	67.5	67.0	67.0
Efforts				
Onsite (%)	25.0	26.0	26.3	26.0
Offshore (%)	75.0	74.0	73.7	74.0
Pricing change				
Onsite (%)	1.4	(1.8)	3.7	1.6
Offshore (%)	0.1	(0.5)	3.7	1.6
BPO				
Revenue Growth (in USD)	11.7	(15.9)	7.7	8.5
Pricing Growth (%)	11.9	3.4	0.3	7.4
Financial assumptions				
Cash yield (%)	7.0	7.0	7.5	7.0
Capex (INR mn)	17,844	58,402	8,651	9,233
Debtor days	90	84	78	78

Income statement

(INR mn)

Year to March	FY16	FY17	FY18E	FY19E
Net revenue	409,130	467,220	523,514	577,075
Cost of revenues	269,010	308,890	345,940	382,056
Gross profit	140,120	158,330	177,574	195,019
Total SG&A expenses	52,170	55,240	62,822	67,656
EBITDA	87,950	103,090	114,753	127,363
Depreciation	5,690	8,340	8,651	9,233
EBIT	82,260	94,750	106,102	118,129
Add: Other income	10,090.00	9,340.00	9,803.91	9,848.73
Profit Before Tax	92,350	104,090	115,906	127,978
Less: Provision for Tax	18,830	19,520	25,499	28,155
Reported Profit	73,520	84,570	90,406	99,823
Adjusted Profit	73,520	84,570	90,406	99,823
Shares o /s (mn)	1,413	1,413	1,414	1,415
Adjusted Basic EPS	52.0	59.9	64.0	70.6
Diluted shares o/s (mn)	1,413	1,413	1,414	1,415
Adjusted Diluted EPS	52.0	59.9	64.0	70.6
Adjusted Cash EPS	56.1	65.8	70.1	77.1
Dividend per share (DPS)	17.0	24.0	26.0	30.0
Dividend Payout Ratio(%)	38.2	46.9	47.6	49.7

Common size metrics

Year to March	FY16	FY17	FY18E	FY19E
Cost of revenues	65.8	66.1	66.1	66.2
Gross margin	34.2	33.9	33.9	33.8
SG&A expenses	12.8	11.8	12.0	11.7
EBITDA margins	21.5	22.1	21.9	22.1
EBIT margins	20.1	20.3	20.3	20.5
Net Profit margins	18.0	18.1	17.3	17.3

Growth ratios (%)

Year to March	FY16	FY17	FY18E	FY19E
Revenues	14.6	14.2	12.0	10.2
EBITDA	(0.2)	17.2	11.3	11.0
PBT	0.7	12.7	11.4	10.4
Adjusted Profit	0.6	15.0	6.9	10.4
EPS	0.5	15.1	6.8	10.3

Balance sheet		(INR mn)			
As on 31st March	FY16	FY17	FY18E	FY19E	
Share capital	2,820	2,827	2,825	2,827	
Reserves & Surplus	277,403	332,076	384,710	434,891	
Shareholders' funds	280,223	334,903	387,535	437,718	
Long term borrowings	9,732	5,417	4,417	3,417	
Total Borrowings	9,732	5,417	4,417	3,417	
Sources of funds	289,955	340,320	391,952	441,135	
Net Block	43,231	46,806	36,603	25,818	
Intangible Assets	64,194	114,256	114,256	114,256	
Total Fixed Assets	107,425	161,062	150,859	140,074	
Non current investments	112,837	115,119	115,119	115,119	
Cash and Equivalents	7,293	13,165	42,911	98,583	
Sundry Debtors	107,228	108,026	116,815	128,606	
Loans & Advances	62,892	66,950	84,856	90,987	
Current Assets (ex cash)	170,120	174,976	201,671	219,593	
Trade payable	107,720	124,002	118,609	132,233	
Total Current Liab	107,720	124,002	118,609	132,233	
Net Curr Assets-ex cash	62,400	50,974	83,062	87,359	
Uses of funds	289,955	340,320	391,952	441,135	
BVPS (INR)	198.3	237.1	274.1	309.4	

Profitability and efficiency ratios

Year to March	FY16	FY17	FY18E	FY19E
ROAE (%)	27.9	27.5	25.0	24.2
ROACE (%)	34.1	33.0	31.7	30.7
Debtors Days	90	84	78	78
Payable Days	144	137	128	120
Cash Conversion Cycle	(54)	(53)	(50)	(42)
Current Ratio	1.6	1.5	2.1	2.4

Peer comparison valuation

Name	Market cap (USD mn)	Diluted P/E (X)		EV / EBITDA (X)		ROAE (%)	
		FY18E	FY19E	FY18E	FY19E	FY18E	FY19E
HCL Technologies	18,593	13.1	11.9	10.0	8.6	25.0	24.2
Cyient	928	13.8	12.3	8.8	7.2	19.0	18.4
ECLERX SERVICES	824	14.2	12.8	8.3	7.3	28.9	28.1
Hexaware Technologies	1,180	16.4	15.4	11.1	10.1	26.2	26.0
Infosys	33,686	14.0	12.9	9.0	7.8	21.6	22.0
Persistent Systems	726	13.0	11.3	6.7	5.2	18.4	18.6
Tata Consultancy Services	71,914	16.8	15.7	11.9	10.8	28.4	25.9
Tech Mahindra	6,580	11.3	9.4	6.0	4.8	19.8	20.3
Wipro	19,067	13.8	12.8	10.5	9.5	16.6	16.4
Median	-	13.8	12.8	9.0	7.8	21.6	22.0
AVERAGE	-	14.0	12.7	9.1	7.9	22.7	22.2

Source: Edelweiss research

Operating ratios		FY16	FY17	FY18E	FY19E
Year to March					
Total Asset Turnover		1.5	1.5	1.4	1.4
Fixed Asset Turnover		4.1	3.5	3.4	4.0
Equity Turnover		1.6	1.5	1.4	1.4

Du pont analysis

Year to March	FY16	FY17	FY18E	FY19E
Net Profit Margin	18.0	18.1	17.3	17.3
Total Asset Turnover	1.5	1.5	1.4	1.4
Leverage Multiplier	1.0	1.0	1.0	1.0
ROAE (%)	27.9	27.5	25.0	24.2

Valuation parameters

Year to March	FY16	FY17	FY18E	FY19E
Adj. Diluted EPS (INR)	52.0	59.9	64.0	70.6
Y-o-Y growth (%)	0.5	15.1	6.8	10.3
Adjusted Cash EPS (INR)	56.1	65.8	70.1	77.1
Diluted P/E (x)	16.1	14.0	13.1	11.9
P/B (x)	4.2	3.5	3.1	2.7
EV / Sales (x)	2.9	2.5	2.2	1.9
EV / EBITDA (x)	13.5	11.4	10.0	8.6
Dividend Yield (%)	2.0	2.9	3.1	3.6

Additional Data

Directors Data

Mr. Shiv Nadar	Chairman & Chief Strategy Officer	Ms. Robin Abrams	Non- Executive Director
Mr. Amal Ganguli	Non- Executive Director	Mr. R. Srinivasan	Non- Executive Director
Mr. Sudhindar Krishan Khanna	Non- Executive Director	Mr. Sosale Shankara Sastry	Non- Executive Director
Roshni Nadar Malhotra	Non Executive Director	Keki Mistry	Non Executive Independent Director
Subramanian Madhavan	Non Executive Independent Director	Thomas Sieber	Independent Director

Auditors - S.R.Batliboi & Co., Chartered Accountants

**as per last annual report*

Holding - Top10

	Perc. Holding		Perc. Holding
Artisan	3.35	Max New York Life Insurance	1.45
Blackrock	1.41	Life Insurance Corporation of India	1.36
ICICI Prudential Life Insurance	1.29	Vanguard Group Inc	1.22
Reliance Capital Trustee Co Ltd	1.18	Lazard	1.12
SBI Funds Management	0.87	HSBC	0.71

**as per last available data*

Bulk Deals

Data	Acquired / Seller	B/S	Qty Traded	Price
23 Mar 2017	Hcl Avitas Pvt Ltd	Buy	7500000	870.00
23 Mar 2017	Vama Sundari Investments (Delhi) Pvt Ltd	Sell	7500000	870.00

**in last one year*

Insider Trades

Reporting Data	Acquired / Seller	B/S	Qty Traded
28 Mar 2017	VAMA SUNDARI INVESTMENTS (DELHI) PRIVATE LIMITED	Sell	16750000.00
06 Mar 2017	Karan Puri	Sell	25000.00
06 Mar 2017	Ashish K Gupta	Sell	18600.00
02 Mar 2017	Rahul Singh	Sell	20000.00
28 Feb 2017	Rahul Singh	Sell	20000.00

**in last one year*

Company	Absolute reco	Relative reco	Relative risk	Company	Absolute reco	Relative reco	Relative Risk
Cyient	BUY	SP	H	ECLERX SERVICES	HOLD	SP	M
HCL Technologies	BUY	SP	H	Hexaware Technologies	HOLD	SP	M
Info Edge	BUY	SP	M	Infosys	BUY	SO	L
Just Dial	REDUCE	SU	M	Persistent Systems	BUY	SP	L
Tata Consultancy Services	HOLD	SP	L	Tech Mahindra	BUY	SP	M
Wipro	BUY	SP	L				

ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return

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Coverage group(s) of stocks by primary analyst(s): IT

Cyient, ECLERX SERVICES, HCL Technologies, Hexaware Technologies, Infosys, Info Edge, Just Dial, Persistent Systems, Tata Consultancy Services, Tech Mahindra, Wipro

Recent Research

Date	Company	Title	Price (INR)	Recos
06-May-17	Cyient	Well entrenched on growth path; <i>Company Update</i>	514	Buy
05-May-17	Cognizant	Realignment underway; pushing for margin expansion; <i>Result Excerpts</i>		
02-May-17	Persistent Systems	At inflection point; huge potential upside ; <i>Visit Note</i>	587	Buy

Distribution of Ratings / Market Cap

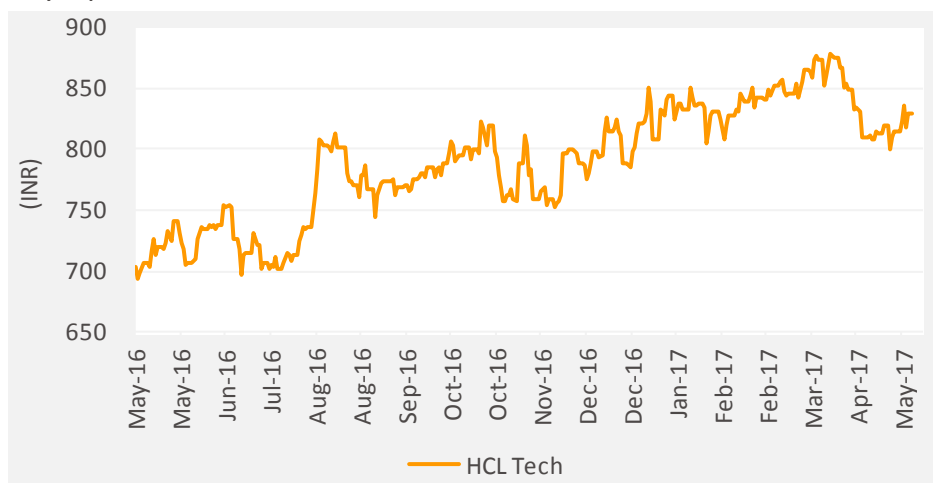
Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	161	67	11	240
* 1stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	156	62	11	

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

One year price chart



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