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HCL Technologies

Strong seasonality in IBM IP aids growth beat

Q3FY18 Result Update

January 20, 2018

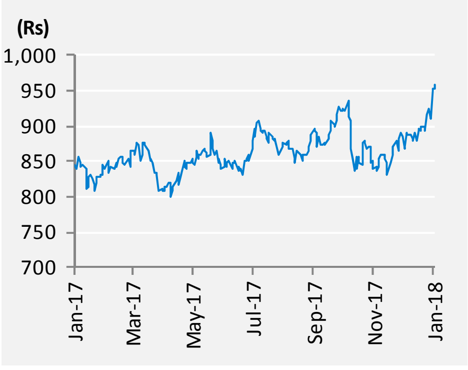
Madhu Babu
madhubabu@plindia.com
+91-22-66322300

Rating	**BUY**
Price	Rs958
Target Price	Rs1,020
Implied Upside	6.5%
Sensex	35,512
Nifty	10,895

(Prices as on January 19, 2018)

Trading data			
Market Cap. (Rs bn)			1,332.2
Shares o/s (m)			1,391.0
3M Avg. Daily value (Rs m)			1495.4
Major shareholders			
Promoters			60.19%
Foreign			25.62%
Domestic Inst.			10.51%
Public & Other			3.68%
Stock Performance			
(%)	**1M**	**6M**	**12M**
Absolute	10.1	7.1	13.5
Relative	5.2	(4.1)	(16.5)
How we differ from Consensus			
EPS (Rs)	**PL**	**Cons.**	***% Diff.***
2019	67.9	66.9	*1.5*
2020	74.8	72.0	*3.9*

Price Performance (RIC: HCLT.BO, BB: HCLT IN)



Source: Bloomberg

HCL Tech 3QFY18 results delivered a beat on USD revenues albeit were inline on EBIT margin and PAT. Constant currency revenue growth for the quarter stood at 3.3% and above our estimates (Ple: 2.5%). Engineering Services up 13.6% QoQ and 47% YoY drove growth for the quarter. EBIDTA margins at 23.1% for 3QFY18 was up 90bps QoQ and above our estimates (Our ests :22.2%). However, Increase in amortization has hit EBIT margin which came at 19.6% down 10bps QoQ and inline with estimates (our ests : 19.6%). PAT was inline estimates. HCL Tech has further added to its IP assets in 3QFY18 with additional partnerships. Company has spent USD310mn during the quarter for further IP asset acquisitions. Hence, total Intangible asset on account of Licensed IPR as on 3QFY18 stood USD1.14bn. 3QFY18 revenue beat was accompanied by higher amortization. As IBM IP product revenues tend have strong seasonality in 3Q, this has aided in 3Q revenue beat. HCL Tech amortization for IP products is linked to IP revenues. Hence, company has seen spurt in amortization in 3Q which restricted EBIT margin and PAT for the quarter.

HCL Tech retained constant currency revenue growth at 10.5-12.5% for FY18 (USD revenue growth upped to 12.1-14.1% YoY). Management guided deal signing remain at 12 quarter high and anticipates strong revenue growth from 1HFY19E. We estimate HCL Tech USD revenue growth assumptions to 12.1/11% for FY18/FY19E (vs 12/10.5% modelled earlier). Organic USD revenue growth for FY18 would be 7%(Constant currency organic growth for FY18 would be 5% which is marginally below peers Infosys/TCS). Our EPS estimates are retained at Rs63/68/75/sh for FY19/FY20E. Stock trades at 14x FY19E EPS and 12.7x FY20E EPS which is reasonable. Softer organic revenue growth for FY18E and high quantum of investment in acquisition of IP assets is constraining P/E multiple expansion. Retain BUY with TP increased by 5% to Rs1020/sh(13.5x FY20E EPS) led by rollover to FY20E EPS.

Key financials (Y/e March)	**2017**	**2018E**	**2019E**	**2020E**
Revenues (Rs m)	468,365	506,033	567,868	624,030
Growth (%)	*49.9*	*8.0*	*12.2*	*9.9*
EBITDA (Rs m)	103,330	113,095	123,784	136,039
PAT (Rs m)	84,750	88,395	94,658	104,254
EPS (Rs)	59.1	63.4	67.9	74.8
Growth (%)	*46.2*	*7.3*	*7.1*	*10.1*
Net DPS (Rs)	23.6	15.9	17.0	18.7

Profitability & Valuation	**2017**	**2018E**	**2019E**	**2020E**
EBITDA margin (%)	*22.1*	*22.3*	*21.8*	*21.8*
RoE (%)	*27.6*	*25.4*	*24.0*	*22.5*
RoCE (%)	*25.9*	*24.2*	*23.0*	*21.7*
EV / sales (x)	2.7	2.4	2.1	1.8
EV / EBITDA (x)	12.1	10.9	9.5	8.1
PE (x)	16.2	15.1	14.1	12.8
P / BV (x)	4.1	3.7	3.1	2.7
Net dividend yield (%)	*2.5*	*1.7*	*1.8*	*2.0*

Source: Company Data; PL Research

Exhibit 1: Consolidated P&L: Revenue miss; Margin beat

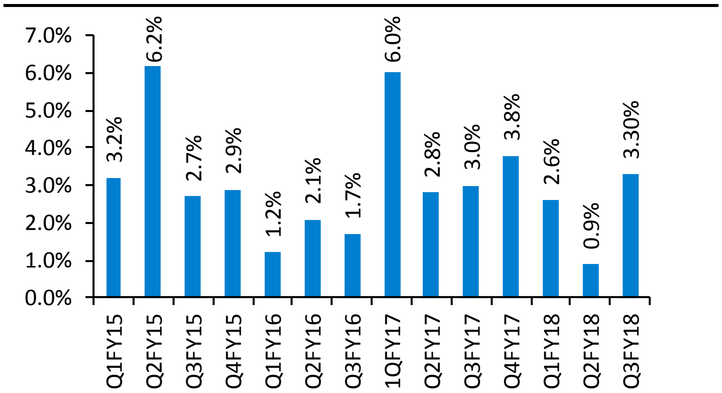
(Rs mn)	Q3FY18	Q2FY18	QoQ gr.	Q3FY17	YoY gr.	Ple	Var (Actual vs Est)
Sales ($ m)	1987.5	1928.0	3.1%	1745.0	13.9%	1975.0	0.6%
Sales	128,080	124,340	3.0%	118,140	8.4%	127,373	0.6%
EBITDA	29,618	27,593	7.3%	26,280	12.7%	28,022	5.7%
EBITDA Margin	*23.1%*	*22.2%*	*93.3*	*22.2%*	*87.9*	*22.0%*	
PAT	21,915	21,872	0.2%	20,710	5.8%	21,914	0.0%

Source: Company Data, PL Research

- **Revenues beat expectations:** Revenues stood at USD1,988mn, up 3.1% QoQ and above our estimates (PLe: USD1,970mn). Constant currency growth for the quarter was 3.3% above our estimates (PLe: 2.5%). Strong growth in IBM IP portfolio (which typically has higher growth in Oct-Dec quarter) appears to have aided growth beat. HCL Tech cited that deal signing is at 12 quarter high and anticipates revenue acceleration from 1HFY19E. HCL Tech cited that it has won 20 transformational deals which are well-balanced across Mode 1, 2,3 services mix. A majority of this wins were in digital cloud, autonomic and AI-based offerings.

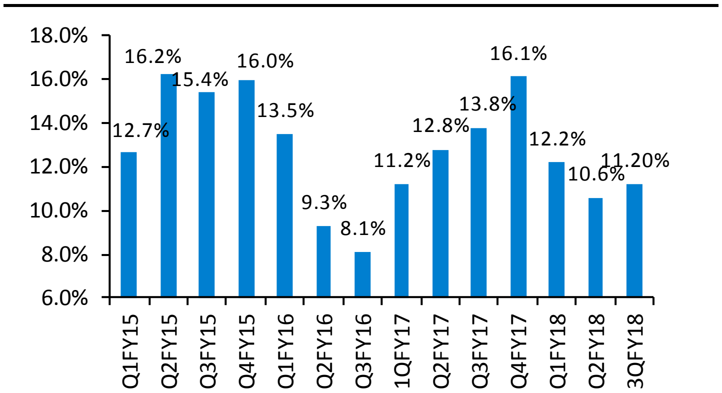
- IMS(~37% of total revenues) revenues were down 1.2% QoQ and up only 5% QoQ. We believe the current quarter weakness in owing to softness in India. This is visible in revenues from ROW which were down 4% QoQ. However, HCL Tech' YoY growth in IMS business has also showed marked deceleration (also partly attributed to rampdown in India business). **HCL tech cited that half of the overall IMS business in Data center related which is seeing pressure from cloud adoption**. The remaining half of IMS business would be in Digital Work based Services, Network Management and Security which offer potential for traction.

Exhibit 2: Constant currency Revenue growth QoQ (%)



*Source: Company Data, PL Research * Acquisitions contributed to growth in 1QFY17,4QFY17 and 1QFY18.*

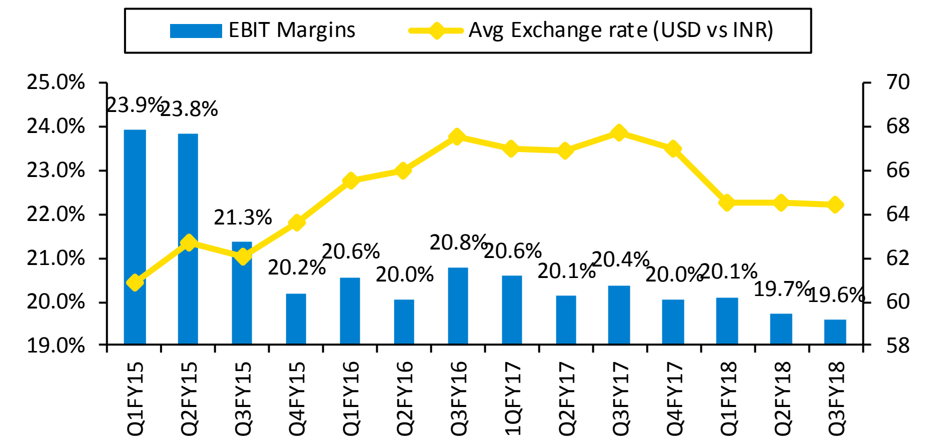
Exhibit 3: Constant Currency Revenue growth YoY (%)



Source: Company Data, PL Research, Acquisitions aiding stronger YoY growth of HCL Tech (vs peers)

- **Margins inline with expectations:** EBIT margin stood at 19.6%, down 10bps QoQ and inline with our estimates. Management has retained EBIT margin band of 19.5-20.5% for FY18. Higher amortization is weighing on EBIT margin trajectory.

Exhibit 4: EBIT Margin vs. Average Rupee rate



Source: Company Data, PL Research

Investments in acquisition of IP assets continues in 3QFY18

- HCL Tech has invested in the extended partnership with IBM in current quarter as well. HCL Tech has committed USD310mn during the quarter for further IP investments. Post the recent partnership, company has a total USD1.14bn in Licensed IPR as Intangible asset on balance sheet. While HCL Tech amortization strategy for IP assets is linked to revenue generated from these IP assets, a significant portion of amortization has been scheduled beyond FY22.

Exhibit 5: Consolidated Cash flows of HCL Tech (USD mn)

Fig in USD mn	13-Jun	14-Jun	15-Jun	9M FY16	FY17	1QFY18	2QFY18	3QFY18
Net income	746	1,037	1,164	840	1,262	337	339	340.3
Depreciation and Amortization	123	119	72	67	125	37	48	70.6
Others	1	(30)	(91)	(53)	17	11	(11)	(7)
Accounts Receivable	(143)	(241)	(287)	(166)	(33)	(38)	(40)	(50)
Other Assets	(98)	(10)	(101)	(82)	9	23	(32)	(6)
Current Liabilities	206	220	217	27	28	39	(40)	(98)
Net cash provided by operating activities	834	1,087	974	632	1,407	408	264	250
Cash flows from investing activities								
Purchase of Property and Equipment (net)	(106)	(118)	(195)	(139)	(197)	(51)	(54)	(50)
Payment for acquisitions and IP deals				(178)	(457)	(186)	(102)	(311)
Free Cash Flow	728	969	780	315	751	170	108	(110)
OCF/EBIDTA (%)	78.5	77	69.7	61.5	91.4	98	62	54
FCF/EBIDTA (%)	68.5	68.7	55.8	48	42.9	41.0	25.3	(23.9)

Source: Company Data, PL Research

In 3QFY18, HCL added an IP partnership with a leading global technology major which includes areas of remote management and provisioning software. HCL also expanded its existing IP partnership in the areas of software solutions for application release automation & governance, endpoint lifecycle management and forms development applications for web and mobile. We believe company appears to be creating a stream of revenues from the Software IP product business.

"So as you know through the IP partnerships, we believe that it's first compelling financial model. One it is built off a lot of the underlying strengths and capabilities of HCL from a services point of you. But that isn't the endpoint of the strategy. Our aspiration is to build a large scale software business. Really with the capabilities from engineering and capabilities around the IP partners, but then also developing organic IP deal and really building had a complete value chain. From the development of the products, all the way through selling it successfully." HCL Tech CEO in 3QFY18 concall.

Key Metrics

Exhibit 6: Geography Mix (%)

% Of revenues	4QFY15	1QFY16	2QFY16	3QFY16	1QFY17	2QFY17	3QFY17	4QFY17	1QFY18	2QFY18	3QFY18
America	57.5	58.6	58.7	61.0	62.5	59.9	61.9	61.9	62.6	62.4	63.5
Europe	31.0	30.4	31.7	29.9	28.4	31.4	29.3	29.6	27.7	29.1	28.7
Asia Pacific	11.5	11.0	9.6	9.1	9.1	8.7	8.8	8.5	9.7	8.5	7.9

Source: Company Data, PL Research

Exhibit 7: Geography-wise revenues and revenue growth

USD mn	Q3FY18	Q2FY18	*QoQ gr.*	Q3FY17	*YoY gr.*
America	1262.1	1203.1	*4.9%*	1080.2	*16.8%*
Europe	570.4	561.0	*1.7%*	516.5	*10.4%*
Asia Pacific	157.0	163.9	*-4.2%*	148.3	*5.9%*

Source: Company Data, PL Research

Exhibit 8: Vertical Mix (%)

% of revenues	2QFY16	3QFY16	1QFY17	2QFY17	3QFY17	4QFY17	1QFY18	2QFY18	3QFY18
Financial Services	25.9	25.0	23.6	24.1	24.3	24.2	24.9	25.0	24.6
Manufacturing	31.5	31.4	33.2	32.2	33.9	34.6	34.9	35.4	36.5
Life sciences and Healthcare	12.2	12.8	11.9	12.6	12.0	11.5	11.8	11.7	11.7
Public services	10.6	11.1	11.7	10.9	11.2	11.7	11.1	10.6	10.2
Retail and CPG	9.5	9.2	10.0	10.4	9.4	9.2	9.5	9.3	9.6
Telecommunication, Media, Publishing Entertainment	9.7	9.9	9.1	9.4	8.9	8.4	7.9	7.9	7.4
Others	0.6	0.5	0.5	0.4	0.4	0.3	NA	NA	NA

Source: Company Data, PL Research

Manufacturing and Retail CPG delivered growth for the quarter.

Exhibit 9: Vertical-wise revenues and revenue growth

USD mn	Q3FY18	Q2FY18	*QoQ gr.*	Q3FY17	*YoY gr.*
Financial Services	488.9	482.0	*1.4%*	424.0	*15.3%*
Manufacturing	725.4	682.5	*6.3%*	591.6	*22.6%*
Life science and Healthcare	232.5	225.6	*3.1%*	209.4	*11.0%*
Public services	202.7	204.4	*-0.8%*	195.4	*3.7%*
Retail and CPG	190.8	179.3	*6.4%*	164.0	*16.3%*
Telecom ,Media,& Entertainment	147.1	152.3	*-3.4%*	155.3	*-5.3%*
Others	0.0	0.0	*NA*	7.0	*NA*

Source: Company Data, PL Research

Exhibit 10: Service Mix (%)

% of revenues	3QFY16	1QFY17	2QFY17	3QFY17	4QFY17	1QFY18	2QFY18	3QFY18
Engineering and R&D services	18.7	17.7	17.8	18.6	20.5	21.5	22.0	24.2
Custom App Dev	39.9	38.3	37.8	37.5	36.8	36.3	35.9	35.3
Infrastructure services	36.2	39.8	40.3	39.8	38.8	38.6	38.5	36.7
BPO services	5.2	4.1	4.1	4.0	3.9	3.6	3.6	3.7

Source: Company Data, PL Research

Exhibit 11: Services-wise revenues and growth

USD mn	Q3FY18	Q2FY18	*QoQ gr.*	Q3FY17	*YoY gr.*
Engineering and R&D services	481.0	424.2	*13.4%*	324.6	*48.2%*
Application Services	701.6	692.2	*1.4%*	654.4	*7.2%*
Infrastructure services	729.4	743.1	*-1.8%*	694.5	*5.0%*
BPO services	73.5	69.4	*5.9%*	69.8	*5.4%*

Source: Company Data, PL Research

Exhibit 12: Client Concentration

Client Concentration	2QFY16	3QFY16	1QFY17	2QFY17	3QFY17	4QFY17	1QFY18	2QFY18	3QFY18
Top 5 clients	13.6	13.6	13.9	13.8	14.2	14.7	14.4	15.1	15.8
Top 10 clients	21.7	21.8	21.8	21.6	21.7	22.1	22.4	22.9	23.5
Top 20 clients	32.4	32.2	31.7	31.8	31.9	32.9	33.0	33.2	33.5

Source: Company Data, PL Research

Exhibit 13: Headcount Details

	2QFY16	3QFY16	1QFY17	2QFY17	3QFY17	4QFY17	1QFY18	2QFY18	3QFY18
Total employee count	103,696	104,896	107,968	109,795	111,092	115,973	117,781	119,040	119291
% Growth	-1.80%	1.20%	2.90%	1.70%	1.20%	4.40%	1.60%	1.10%	0.2%
Gross additions	6,234	9,280	10,515	9,083	8,467	10,605	9,462	8,645	7113
Net additions	(1,875)	1,200	3,072	1,827	1,297	4,881	1,808	1,259	251
Employees Leaving	8,109	8,080	7,443	7,256	7,170	5,724	7,654	7,386	6862
Attrition	16.70%	17.30%	17.80%	18.60%	17.90%	16.90%	16.20%	15.90%	15.2%

Source: Company Data, PL Research

Financial Snapshot

Exhibit 14: Yearly financial snapshot of HCL Tech

	Jun-12	Jun-13	Jun-14	Jun-15	9M FY16	FY17	FY18E	FY19E	FY20E
Revenues- USD mn	**4,152**	**4,687**	**5,360**	**5,952**	**4697**	**6,975**	**7,819**	**8,670**	**9,600**
Growth (%)	17.1%	12.9%	14.4%	11.1%	NA	11.9%	12.1%	10.9%	10.7%
Average exchange rate (USD vs INR)	50.5	54.9	61.5	62.3	66.5	67.2	64.7	65.5	65.0
Consolidated revenues (Rs mn)	**209,630**	**257,183**	**329,440**	**370,880**	**312,390**	**468,365**	**506,033**	**567,868**	**624,030**
Growth (%)	32.2%	22.7%	28.1%	12.6%	NA	49.9%	8.0%	12.2%	9.9%
EBITDA (Rs mn)	**39,896**	**58,316**	**86,733**	**86,984**	**68,335**	**103,330**	**113,095**	**123,784**	**136,039**
EBIT (Rs mn)	34,261	51,588	79,407	82,485	63,873	94,957	100,443	111,859	122,934
PAT (Rs mn)	25,013	40,942	63,751	72,490	56,824	84,750	88,395	94,658	104,254
EBITDA Margins (%)	19.0%	22.7%	26.3%	23.5%	21.9%	22.1%	22.3%	21.8%	21.8%
EBIT Margins (%)	16.3%	20.1%	24.1%	22.2%	20.4%	20.3%	19.8%	19.7%	19.7%
NPM (%)	47.8%	63.7%	55.7%	13.7%	NA	18.1%	17.5%	16.7%	16.7%
EPS	**17.8**	**29.0**	**45.1**	**51.4**	**40.3**	**59.9**	**63.4**	**68**	**75**
Growth (%)	46.9%	62.8%	55.3%	13.9%	NA	NA	5.8%	7.1%	10.1%
P/E	47.48	29.16	18.78	16.49	15.78	15.35	15.0	14.0	12.7
EV/EBITDA	29.5	19.4	12.6	12.4	11.9	11.4	10.8	9.4	8.0
Consolidated balance sheet (Rs mn)									
Net cash on balance sheet (Rs mn)	27,050	49,810	99,998	117,890	118,524	126,818	108,030	169,224	243,433
Net cash per share	5.7	30.8	66.2	80.6	77.4	85.9	73.6	117.5	170.7
Net cash per share/ Stock price	0.7%	3.6%	7.8%	9.5%	9.1%	9.3%	7.7%	12.4%	18.0%
Consolidated cash flows (Rs mn)									
Cash flow from operations	28,326	49,543	65,409	62,001	41,868	91,283	82,088	100,910	111,027
Capex + Acquisitions	(9,948)	(6,301)	(7,101)	(12,380)	(20,999)	(42,568)	(41,840)	(14,000)	(9,000)
Free cash flows	18,378	43,242	58,308	49,622	20,869	48,715	40,248	86,910	102,027

*Source: Company Data, PL Research *Please note FY16 is for 9M as company moved from June year ending to March year ending.*

Income Statement (Rs m)

Y/e March	2017	2018E	2019E	2020E
Net Revenue	**468,365**	**506,033**	**567,868**	**624,030**
Raw Material Expenses	—	—	—	—
Gross Profit	468,365	506,033	567,868	624,030
Employee Cost	309,662	333,977	375,940	413,108
Other Expenses	55,372	58,961	68,144	74,884
EBITDA	**103,330**	**113,095**	**123,784**	**136,039**
Depr. & Amortization	8,374	12,652	11,925	13,105
Net Interest	—	—	—	—
Other Income	9,367	11,248	9,498	10,725
Profit before Tax	**104,324**	**111,691**	**121,356**	**133,659**
Total Tax	19,574	23,296	26,698	29,405
Profit after Tax	**84,750**	**88,395**	**94,658**	**104,254**
Ex-Od items / Min. Int.	—	—	—	—
Adj. PAT	**84,750**	**88,395**	**94,658**	**104,254**
Avg. Shares O/S (m)	**1,433.7**	**1,394.0**	**1,394.0**	**1,394.0**
EPS (Rs.)	**59.1**	**63.4**	**67.9**	**74.8**

Balance Sheet Abstract (Rs m)

Y/e March	2017	2018E	2019E	2020E
Shareholder's Funds	334,904	361,692	427,858	500,732
Total Debt	5,417	5,417	5,417	5,417
Other Liabilities	12,525	12,025	11,525	11,025
Total Liabilities	**352,846**	**379,134**	**444,800**	**517,174**
Net Fixed Assets	46,806	75,994	78,069	73,964
Goodwill	114,256	114,256	114,256	114,256
Investments	—	—	—	—
Net Current Assets	153,199	150,300	213,891	290,369
Cash & Equivalents	*126,818*	*108,030*	*169,224*	*243,433*
Other Current Assets	*137,858*	*146,249*	*161,353*	*175,162*
Current Liabilities	*111,477*	*103,979*	*116,685*	*128,225*
Other Assets	38,584	38,584	38,584	38,584
Total Assets	**352,845**	**379,134**	**444,800**	**517,174**

Cash Flow Abstract (Rs m)

Y/e March	2017	2018E	2019E	2020E
C/F from Operations	91,283	82,088	100,910	111,027
C/F from Investing	(42,127)	(26,769)	(10,725)	(4,938)
C/F from Financing	(43,138)	(62,107)	(28,992)	(31,880)
Inc. / Dec. in Cash	6,018	(6,789)	61,193	74,209

Quarterly Financials (Rs m)

Y/e March	Q4FY17	Q1FY18	Q2FY18	Q3FY18
Net Revenue	**120,530**	**121,490**	**124,340**	**128,080**
EBITDA	**26,490**	**26,810**	**27,590**	**29,640**
% of revenue	*22.0*	*22.1*	*22.2*	*23.1*
Depr. & Amortization	2,330	2,360	3,080	4,550
Net Interest	—	—	—	—
Other Income	2,150	2,690	2,980	2,640
Profit before Tax	**26,310**	**27,140**	**27,490**	**27,730**
Total Tax	3,030	5,430	5,610	5,790
Profit after Tax	**23,280**	**21,710**	**21,880**	**21,940**
Adj. PAT	**23,280**	**21,710**	**21,880**	**21,940**

Source: Company Data, PL Research.

Key Financial Metrics

Y/e March	2017	2018E	2019E	2020E
Growth				
Revenue (%)	49.9	8.0	12.2	9.9
EBITDA (%)	51.2	9.4	9.5	9.9
PAT (%)	49.1	4.3	7.1	10.1
EPS (%)	46.2	7.3	7.1	10.1
Profitability				
EBITDA Margin (%)	22.1	22.3	21.8	21.8
PAT Margin (%)	18.1	17.5	16.7	16.7
RoCE (%)	25.9	24.2	23.0	21.7
RoE (%)	27.6	25.4	24.0	22.5
Balance Sheet				
Net Debt : Equity	(0.4)	(0.3)	(0.4)	(0.5)
Net Wrkng Cap. (days)	—	—	—	—
Valuation				
PER (x)	16.2	15.1	14.1	12.8
P / B (x)	4.1	3.7	3.1	2.7
EV / EBITDA (x)	12.1	10.9	9.5	8.1
EV / Sales (x)	2.7	2.4	2.1	1.8
Earnings Quality				
Eff. Tax Rate	18.8	20.9	22.0	22.0
Other Inc / PBT	9.0	10.1	7.8	8.0

Source: Company Data, PL Research.

Prabhudas Lilladher Pvt. Ltd.

3rd Floor, Sadhana House, 570, P. B. Marg, Worli, Mumbai-400 018, India

Tel: (91 22) 6632 2222 Fax: (91 22) 6632 2209

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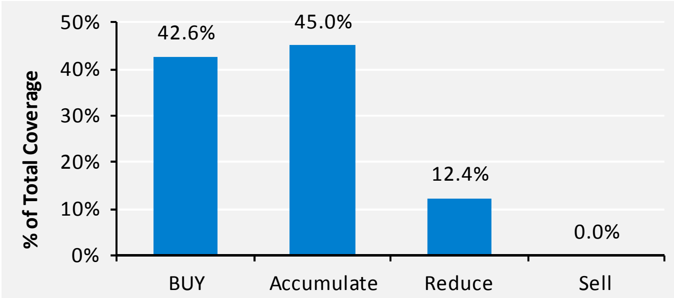

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BUY	:	Over 15% Outperformance to Sensex over 12-months
Accumulate	:	Outperformance to Sensex over 12-months
Reduce	:	Underperformance to Sensex over 12-months
Sell	:	Over 15% underperformance to Sensex over 12-months
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