

HCL TECHNOLOGIES

Weak revenue outlook shadows margin stability

India Equity Research | IT

HCL Technologies' (HCLT) Q4FY18 revenue and operating margin at USD2,038mn (up 2.5% in USD) and 19.6%, respectively, were slightly below Street's estimate of 3.2% and 19.8%. The key disappointment was muted organic growth guidance of 4.25-6.25% (CC) for FY19 versus 6-9% expectation; margin guidance was maintained at 19.5-20.5%. Key highlights: 1) management expects IMS services growth to improve in FY19; 2) will invest further in IP deals to expand Mode 2 & 3 capabilities; 3) mode 2 & 3 services contributed 23.4% to total revenue (up ~42%); and 4) won 15 large transformational deals during the quarter. We believe, the revenue guidance is much weaker than anticipated due to expected leakage from legacy services, although stable margin will enable 10.7% PAT CAGR over FY18-20E. Maintain 'BUY' with TP of INR1,225 as reasonable valuation protects downside.

Weak guidance despite robust Mode 2 & 3 business

HCLT's weak FY19 revenue guidance of 4.25-6.25% (cc) despite robust growth in Mode 2 & 3 services (up 41.5% in FY18, although includes inorganic) implies a leaking bucket of traditional services which has not been fixed and will leak further going forward. The above, in spite of global recovery, expected turnaround in IMS and sustenance of momentum in product engineering space implies big dent in either large clients or legacy services.

Stable margin only solace amidst weak guidance

Management maintained operating margin guidance of 19.5-20.5% in spite of weak revenue guidance. This implies steady margin improvement in core business as C3I is a mere ~6% margin business with estimated revenue of ~USD180mn in FY19. This will ensure earnings momentum going forward.

Outlook and valuations: Weak guidance to weigh; maintain 'BUY'

HCLT is trying to make up for late investments in new technologies via IP partnerships and investments in Mode 2 & 3 services. However, it has failed to fix the leakage in application services and, to some extent, in IMS. Stable margin guidance implies that PAT CAGR will be 10.7% over FY18-20E, implying reasonable valuation of 13.1x, thereby protecting the downside. We maintain 'BUY/SP' with target price of INR1,225 (16x FY20E EPS).

Financials

(INR mn)

Year to March	Q4FY18	Q3FY18	% Chg	Q4FY17	% Chg	FY18	FY19E	FY20E
Net revenues	131,790	128,080	2.9	120,530	9.3	505,700	576,535	640,342
EBITDA	30,360	29,640	2.4	26,490	14.6	114,400	135,727	151,175
Adjusted Profit	22,290	21,940	1.6	23,280	(4.3)	87,820	97,504	107,577
Diluted EPS (INR)	16.0	15.7	1.6	16.5	(2.8)	62.6	69.4	76.6
Diluted P/E (x)						16.0	14.4	13.1
EV/EBITDA (x)						12.2	10.3	9.2
EV/Revenues (x)						2.8	2.4	2.2

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 1,000
Target Price	: INR 1,225
52-week range (INR)	: 1,108 / 808
Share in issue (mn)	: 1,392.2
M cap (INR bn/USD mn)	: 1,393 / 21,949
Avg. Daily Vol.BSE/NSE('000)	: 1,787.0

SHARE HOLDING PATTERN (%)

	Current	Q3FY18	Q2FY18
Promoters *	60.2	60.2	60.1
MF's, FI's & BK's	10.5	10.5	9.9
FII's	25.6	25.6	25.3
Others	3.7	3.7	4.7
* Promoters pledged shares (% of share in issue)	:		NIL

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Technology Index
1 month	2.1	6.0	10.8
3 months	1.0	(2.7)	6.9
12 months	21.7	15.2	39.4

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Weak guidance to weigh

HCLT's muted revenue guidance, yet again, raises many questions: 1) is the company buying revenue to overcome the organic growth weakness? 2) will declining revenue of recent acquisitions (C3I and Actian) weigh further on future growth? 3) will the declining revenue impact FY20 margin as well? and 4) has the company strategically missed the digital bus & its over dependency on IMS is playing out?

We believe, lack of clarity from management on the above will have significant bearing on the stock's performance. The saving grace, however, will be the good dividend yield (50% payout) and reasonable valuation with a modest earnings CAGR of 10.7% over FY18-20E.

We certainly believe that it will be difficult for the company to get back to 15-16x P/E due to weak revenue outlook. However, if the next couple of quarters' numbers are modest and meet upper end of guidance, the stock will once again start re-rating as EPS growth still looks modest at 10.7% CAGR over FY18-20E.

Table 1: Growth in Mode 1, 2 and 3 revenues

Revenue mix (%)	FY17	FY18	YoY growth (%)
Mode 1	81.4	76.6	5.7
Mode 2	12.8	14.7	29.4
Mode 3	5.8	8.7	68.3

Source: Company, Edelweiss research

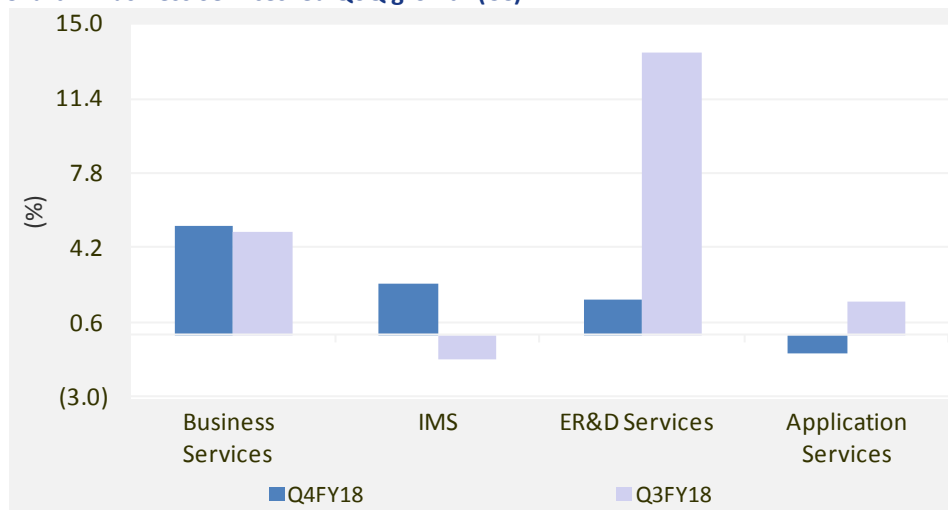
Q4FY18: Key highlights

- Consolidated revenue at USD2,038mn grew 2.5% QoQ versus Street's 3.2% QoQ estimate. In CC terms, revenue grew 1.2% QoQ. In INR terms, revenue rose 2.9% QoQ and 9.3% YoY to INR131.8bn.
- Gross profit stood at INR46.2bn, up 5.1% QoQ and 13.6% YoY. Gross margin, at 35.0%, rose 70bps QoQ. EBITDA stood at INR30.4bn with EBITDA margin at 23.0% (down 10bps QoQ).
- Net profit grew 1.6% QoQ and declined 4.3% YoY to INR22.3bn.
- Net employees stood higher by 790, taking total employee count to 120,081. Gross addition for the quarter was 8,476.

Segmental performance

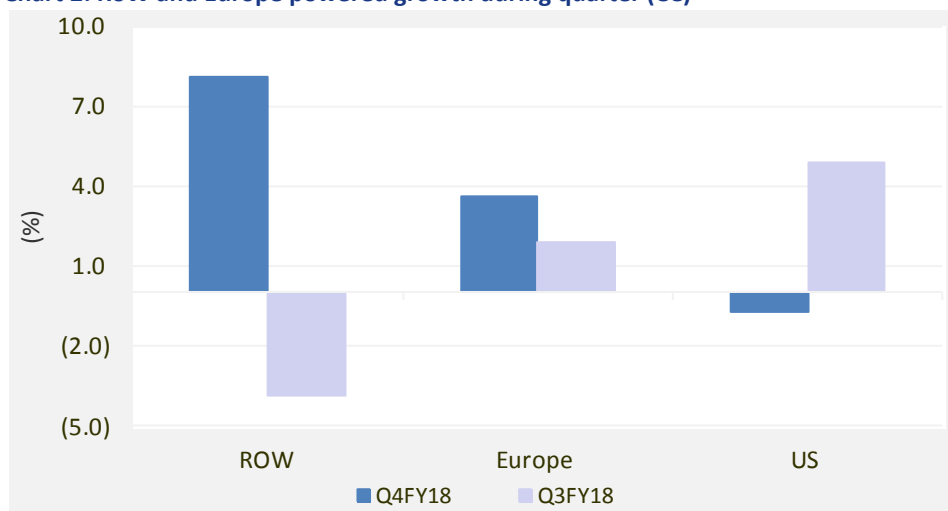
- IT services:** The segment (contributes 96.1% to total revenue) grew 12.2% YoY (2.4% QoQ) to USD1,959mn versus USD1,914mn in previous quarter. Operating margin (EBIT) declined 20bps QoQ to 19.9%.
 - Core software:** Revenue, at USD1,199mn, grew 1.2% QoQ and 15.2% YoY. Operating margin (EBIT), at 19.5%, fell 180bps QoQ.
 - IMS:** Revenue, at USD761mn, rose 4.2% QoQ and 7.9% YoY. EBIT margin rose 240bps QoQ to 20.7%.
- BPO:** Revenue, at USD78.6mn, grew 6.8% QoQ and 10.7% YoY. EBIT margin rose 560bps QoQ to 10.9%.
- Services:** Revenue growth was broad-based across services, i.e., business services (up 5.3% QoQ CC) and infrastructure services (up 2.5% QoQ CC). While ER&D services rose 1.7% QoQ, application services declined 0.9% QoQ in CC.

Chart 1: Business Services led QoQ growth (CC)



- **Geo split:** In CC terms, growth was led by Rest of World (up 8.1% QoQ) and Europe (up 3.6% QoQ), while America declined 0.7% QoQ.

Chart 2: RoW and Europe powered growth during quarter (CC)



Source: Company, Edelweiss research

- Public services; financial services; telecommunications, media, publishing & entertainment; retail & CPG and manufacturing grew 4.1%, 2.0%, 1.8%, 1.1% and 0.2% QoQ, respectively, in CC terms. Lifesciences & healthcare declined 0.2% QoQ in CC.
- **Client addition:** Number of clients contributing USD1mn and USD5mn plus stood at 561 (9 additions QoQ) and 264 (3 additions QoQ), respectively. Number of clients in the USD10mn plus category (160) rose by 4 QoQ. HCLT gained 2 clients each in the USD20mn plus (85 clients) and USD30mn plus (58 clients). USD40mn plus client bucket remained flat QoQ at 40. Number of USD50mn stood at 28 (up by 3) and USD100mn stood at 8 (down by 1).
- **Attrition** in IT services (LTM) stood at 15.5% versus 15.2% in the previous quarter.
- **Utilisation:** Blended utilisation stood at 85.9%, up 10bps QoQ.
- **DSO** stood at 65 days versus 66 in previous quarter.

Financial snapshot

(INR mn)

Year to March	Q4FY18	Q3FY18	% Change	Q4FY17	% Change	FY18	FY19E	FY20E
Net revenues	131,790	128,080	2.9	120,530	9.3	505,700	576,535	640,342
Direct costs	85,600	84,120	1.8	79,870	7.2	332,370	375,660	418,253
Gross profit	46,190	43,960	5.1	40,660	13.6	173,330	200,876	222,089
SG&A	15,830	14,320	10.5	14,170	11.7	58,930	65,148	70,914
EBITDA	30,360	29,640	2.4	26,490	14.6	114,400	135,727	151,175
Depreciation	4,530	4,550	(0.4)	2,330	94.4	14,520	20,179	22,412
EBIT	25,830	25,090	2.9	24,160	6.9	99,880	115,549	128,763
Other income	1,190	1,350	(11.9)	1,670	(28.7)	5,700	6,189	6,450
Foreign exc. gain / (loss)	1,610	1,290	24.8	480	235.4	5,410	3,267	3,733
Profit before tax	28,630	27,730	3.2	26,310	8.8	110,990	125,005	138,947
Provision for taxes	6,340	5,790	9.5	3,030	109.2	23,170	27,501	31,370
Reported net profit	22,290	21,940	1.6	23,280	(4.3)	87,820	97,504	107,577
Adjusted Profit	22,290	21,940	1.6	23,280	(4.3)	87,820	97,504	107,577
Diluted EPS (INR)	16.0	15.7	1.6	16.5	(2.8)	62.6	69.4	76.6
Diluted P/E (x)						16.0	14.4	13.1
EV/EBITDA (x)						12.2	10.3	9.2
EV/Revenues (x)						2.8	2.4	2.2
Tax Rate	22.1	20.9		11.5		20.9	22.0	22.6

As % of net revenues

Gross profit	35.0	34.3		33.7		34.3	34.8	34.7
SG&A	12.0	11.2		11.8		11.7	11.3	11.1
EBITDA	23.0	23.1		22.0		22.6	23.5	23.6
EBIT	19.6	19.6		20.0		19.8	20.0	20.1
Reported net profit	16.9	17.1		19.3		17.4	16.9	16.8

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 120,081 and its revenues for the past twelve months stood at INR505.7bn (USD7.8bn).

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	FY17	FY18	FY19E	FY20E
Macro				
GDP(Y-o-Y %)	6.6	6.5	7.1	7.6
Inflation (Avg)	4.5	3.8	4.5	5.0
Repo rate (exit rate)	6.3	6.0	6.0	6.5
USD/INR (Avg)	67.1	64.5	66.0	66.0
Company				
Efforts				
Onsite (%)	26.0	26.1	26.0	26.0
Offshore (%)	74.0	73.9	74.0	74.0
Onsite (%)	(1.8)	2.0	0.2	-
Offshore (%)	(0.5)	2.0	0.2	-
BPO				
Revenue Growth (in USD)	(15.9)	5.5	2.9	8.8
Pricing Growth (%)	3.4	(2.9)	2.5	4.1
Capex (INR mn)	39,054	53,473	43,264	43,134
Cash yield (%)	7.0	7.0	7.5	7.2
Debtor days	84	83	80	79

Income statement

(INR mn)

Year to March	FY17	FY18	FY19E	FY20E
Net revenue	467,220	505,700	576,535	640,342
Cost of revenues	308,890	332,370	375,660	418,253
Gross profit	158,330	173,330	200,876	222,089
Total SG&A expenses	55,240	58,930	65,148	70,914
EBITDA	103,090	114,400	135,727	151,175
Depreciation	8,340	14,520	20,179	22,412
EBIT	94,750	99,880	115,549	128,763
Add: Other income	9,340.00	11,110.00	9,456.01	10,183.4
Profit Before Tax	104,090	110,990	125,005	138,947
Less: Provision for Tax	19,520	23,170	27,501	31,370
Reported Profit	84,570	87,820	97,504	107,577
Adjusted Profit	84,570	87,820	97,504	107,577
Shares o /s (mn)	1,413	1,404	1,404	1,405
Adjusted Basic EPS	59.9	62.6	69.4	76.6
Diluted shares o/s (mn)	1,413	1,404	1,404	1,405
Adjusted Diluted EPS	59.9	62.6	69.4	76.6
Adjusted Cash EPS	65.8	72.9	83.8	92.5
Dividend per share (DPS)	24.0	8.0	30.0	42.0
Dividend Payout Ratio(%)	46.9	14.9	50.5	48.9

Common size metrics

Year to March	FY17	FY18	FY19E	FY20E
Cost of revenues	66.1	65.7	65.2	65.3
Gross margin	33.9	34.3	34.8	34.7
SG&A expenses	11.8	11.7	11.3	11.1
EBITDA margins	22.1	22.6	23.5	23.6
EBIT margins	20.3	19.8	20.0	20.1
Net Profit margins	18.1	17.4	16.9	16.8

Growth ratios (%)

Year to March	FY17	FY18	FY19E	FY20E
Revenues	14.2	8.2	14.0	11.1
EBITDA	17.2	11.0	18.6	11.4
PBT	12.7	6.6	12.6	11.2
Adjusted Profit	15.0	3.8	11.0	10.3
EPS	15.1	4.5	11.0	10.3

Balance sheet		(INR mn)			
As on 31st March	FY17	FY18	FY19E	FY20E	
Share capital	2,827	2,784	2,784	2,786	
Reserves & Surplus	332,076	365,384	413,609	452,164	
Shareholders' funds	334,903	368,168	416,393	454,950	
Long term borrowings	5,417	4,371	3,371	2,371	
Total Borrowings	5,417	4,371	3,371	2,371	
Sources of funds	340,320	372,539	419,764	457,321	
Net Block	46,806	51,847	74,932	95,654	
Intangible Assets	114,256	144,057	144,057	144,057	
Total Fixed Assets	161,062	195,904	218,989	239,711	
Non current investments	115,119	86,060	86,060	86,060	
Cash and Equivalents	13,165	16,939	11,707	20,304	
Sundry Debtors	108,026	122,575	130,658	145,431	
Loans & Advances	66,950	62,873	90,332	96,867	
Current Assets (ex cash)	174,976	185,448	220,990	242,298	
Trade payable	124,002	111,812	117,982	131,052	
Total Current Liab	124,002	111,812	117,982	131,052	
Net Curr Assets-ex cash	50,974	73,636	103,008	111,246	
Uses of funds	340,320	372,539	419,764	457,321	
BVPS (INR)	237.1	262.2	296.6	323.8	

Profitability and efficiency ratios

Year to March	FY17	FY18	FY19E	FY20E
ROAE (%)	27.5	25.0	24.9	24.7
ROACE (%)	33.0	31.1	31.6	31.7
Debtors Days	84	83	80	79
Payable Days	137	129	112	109
Cash Conversion Cycle	(53)	(46)	(31)	(30)
Current Ratio	1.5	1.8	2.0	2.0

Peer comparison valuation

Name	Market cap (USD mn)	Diluted P/E (X)		EV / EBITDA (X)		ROAE (%)	
		FY19E	FY20E	FY19E	FY20E	FY19E	FY20E
HCL Technologies	21,949	14.4	13.1	10.3	9.2	24.9	24.7
Cyient	1,283	19.1	16.4	12.7	10.9	18.9	19.4
ECLERX SERVICES	772	16.6	13.7	9.7	7.3	21.1	21.9
Hexaware Technologies	1,995	23.6	19.9	16.8	14.4	26.4	26.9
Infosys	39,233	16.8	15.2	11.6	10.1	24.4	26.4
L&T Infotech Ltd	4,042	20.8	17.4	16.1	12.9	31.8	32.2
L&T Technology Services Ltd	2,040	23.0	18.5	17.6	13.9	30.5	31.8
Persistent Systems	968	15.4	13.0	8.9	7.1	17.7	18.4
Tata Consultancy Services	101,254	23.5	21.1	16.9	15.0	30.6	30.4
Tech Mahindra	9,840	15.4	13.4	10.3	8.7	18.6	19.1
Wipro	18,884	14.8	13.4	11.5	10.6	16.8	17.5
Median	-	16.8	15.2	11.6	10.6	24.4	24.7
AVERAGE	-	18.5	15.9	12.9	10.9	23.8	24.4

Source: Edelweiss research

Operating ratios

Year to March	FY17	FY18	FY19E	FY20E
Total Asset Turnover	1.5	1.4	1.5	1.5
Fixed Asset Turnover	3.5	2.8	2.8	2.8
Equity Turnover	1.5	1.4	1.5	1.5

Du pont analysis

Year to March	FY17	FY18	FY19E	FY20E
Net Profit Margin	18.1	17.4	16.9	16.8
Total Asset Turnover	1.5	1.4	1.5	1.5
Leverage Multiplier	1.0	1.0	1.0	1.0
ROAE (%)	27.5	25.0	24.9	24.7

Valuation parameters

Year to March	FY17	FY18	FY19E	FY20E
Adj. Diluted EPS (INR)	59.9	62.6	69.4	76.6
Y-o-Y growth (%)	15.1	4.5	11.0	10.3
Adjusted Cash EPS (INR)	65.8	72.9	83.8	92.5
Diluted P/E (x)	16.7	16.0	14.4	13.1
P/B (x)	4.2	3.8	3.4	3.1
EV / Sales (x)	3.0	2.8	2.4	2.2
EV / EBITDA (x)	13.6	12.2	10.3	9.2
Dividend Yield (%)	2.4	0.8	3.0	4.2

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
Vama sundari investm	42.21	Hcl holdings pvt ltd	16.8
Artisan partners ltd	3.07	Blackrock	1.7
Life insurance corp	1.6	Icici prudential ass	1.49
Icici prudential lif	1.47	Vanguard group	1.32
Lazard ltd	1.08	Sbi funds management	1.05

**in last one year*

Bulk Deals

Data	Acquired / Seller	B/S	Qty Traded	Price
16 May 2017	Vama Sundari Investments (Delhi) Pvt Ltd	Buy	12425000	858.00

**in last one year*

Insider Trades

Reporting Data	Acquired / Seller	B/S	Qty Traded
28 Mar 2018	Rahul Singh	Sell	20000.00
01 Mar 2018	Anand Birje	Sell	16800.00
27 Feb 2018	Anand Birje	Sell	36200.00
02 Feb 2018	Madhumit S. Dixit	Sell	15000.00
30 Jan 2018	Vikram Duvvooi	Sell	28800.00

**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	HOLD	SU	M	L&T Infotech Ltd	BUY	SO	M
L&T Technology Services Ltd	BUY	SO	M	Persistent Systems	BUY	SP	L
Tata Consultancy Services	HOLD	SP	L	Tech Mahindra	BUY	SP	M
Wipro	HOLD	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, L&T Infotech Ltd, L&T Technology Services Ltd, Persistent Systems, Tata Consultancy Services, Tech Mahindra, Wipro

Recent Research

Date	Company	Title	Price (INR)	Recos
26-Apr-18	Tejas Network	Weak quarter; better outlook; <i>Result Update</i>	336	Buy
26-Apr-18	Sterlite Technologies	Tracking strong growth momentum; <i>Result Update</i>	342	Buy
25-Apr-18	Wipro	Client-specific issues mar an otherwise good show; <i>Result Update</i>	287	Hold

Distribution of Ratings / Market Cap

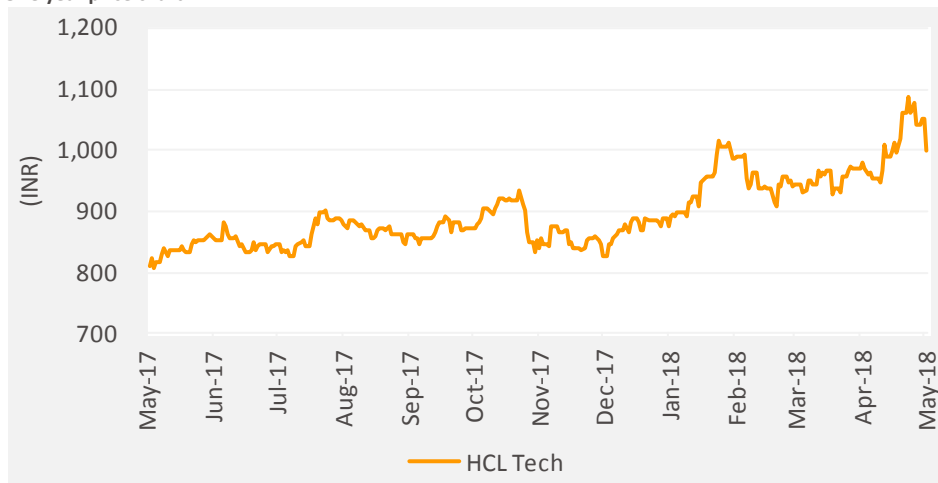
Edelweiss Research Coverage Universe

	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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