

HCL TECHNOLOGIES

Embarking on 'Most bullish' journey

India Equity Research | IT



While HCL Technologies (HCLT) posted Q1FY19 revenue and operating margin growth of 0.8% (in USD) and 19.8% (lower than Street's 2.0% and 19.9%) respectively, management commentary on demand environment is extremely bullish. The company signed a robust number of 27 new transformational deals during the quarter (15 in Q4FY18), calling out the highest-ever deal bookings. In fact, the deal bookings are significantly better than the previous high and are in line with our [most bullish](#) stance. HCLT also benefited from wins in large next-gen infrastructure deals, thereby reinforcing the resurgence even in IMS. Guidance for IT revenue growth (9.5–11.5% cc) and margin (19.5–20.5%) was maintained for FY19. In spite of HCLT's weaker-than-expected results, we believe robust deal-wins ensure sizable revenue acceleration over coming quarters. Valuation at 11.9x FY20E EPS limits downside. Retain 'BUY' with TP of INR1,300.

Record high deal-win resonates 'Most Bullish' demand

Despite revenue coming in USD23mn lower than expected, management maintained its CC FY19 revenue guidance of 9.5–11.5%. Considering the deal pipeline, we expect revenue growth to materially accelerate and, if not breach guidance, then come in towards the upper-end. Deal-wins have been robust in HCLT's key vertical (Financial Services) and services (IMS), which reinforce growth prospects. The USD100mn plus and USD50mn plus clients increased by one and four QoQ, respectively.

Digital deals gaining scale; advantage large caps

Mode 2 and 3 revenues grew at a robust 9.6% QoQ to 26.6% of overall revenue. Management highlighted that enterprise is moving from small tests and proof of concept to the ongoing digital transformation journey, which would benefit large players on account of their scale capabilities and execution excellence.

Outlook and valuations: Higher QoQ growth assured; retain 'BUY'

With all major enterprises planning their technology transformation journey, demand for Indian IT services will continue to accelerate. We believe HCLT, considering its expertise, is well positioned to win large-scale transformation deals. Besides, the stock's current valuation of 11.9x FY20E EPS implies limited downside and a very favourable risk-reward ratio. Maintain 'BUY/SP' with TP of INR1,300 (16x FY20E EPS).

Financials

(INR mn)

Year to March	Q1FY19	Q4FY18	% Chg	Q1FY18	% Chg	FY18	FY19E	FY20E
Net revenues	138,780	131,790	5.3	121,490	14.2	505,700	590,159	668,763
EBITDA	32,250	30,360	6.2	26,810	20.3	114,400	137,294	156,255
Adjusted Profit	24,030	22,290	7.8	21,710	10.7	87,820	98,258	111,000
Diluted EPS (INR)	17.3	16.0	7.8	15.1	14.0	62.6	71.9	81.2
Diluted P/E (x)						15.4	13.4	11.9
EV/EBITDA (x)						11.7	9.5	8.4
EV/Revenues (x)						2.6	2.2	2.0

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 963
Target Price	: INR 1,300
52-week range (INR)	: 1,108 / 825
Share in issue (mn)	: 1,392.4
M cap (INR bn/USD mn)	: 1,342 / 17,739
Avg. Daily Vol.BSE/NSE('000)	: 1,952.9

SHARE HOLDING PATTERN (%)

	Current	Q4FY18	Q3FY18
Promoters *	60.2	60.2	60.2
MF's, FI's & BK's	9.8	9.8	10.5
FII's	26.5	26.5	25.6
Others	3.5	3.5	3.7
* Promoters pledged shares (% of share in issue)	:		NIL

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Technology Index
1 month	6.7	2.3	5.0
3 months	(3.6)	3.7	12.8
12 months	9.7	10.7	40.2

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IMS spends shifting, not declining

The company specified that spends in infrastructure are just shifting to next-gen and technology modernization, rather than declining. Enterprises are embracing cloud to drive innovation and not just for cost efficiencies. Also, going by the huge deal-wins in IMS during the quarter, resurgence of IMS looks imperative. The company won a deal with Nokia with TCV of over USD500mn to be spread over a period of seven years. This deal involves modernization of legacy IT management services for the Finnish telecommunications company and will start contributing to revenue from Q3FY19. During the quarter, the company also consummated the C3i acquisition, which provided a 200bps tailwind to top line.

IP partnership extended; Mode-3 revenue growing well

HCLT extended the IP partnership by investing another USD177mn to include on-premises digital experience software. Giving deeper insights into its IP deals to the investor community, management highlighted that more than 40% of Mode-3 services are in the next-gen tech space. These 40% revenue bucket will clock growth in excess of double-digit. Management also clarified that growth in IP deals will likely to be volatile, in line with revenue of software companies, and CYQ2 and CYQ3 are expected to be by and large soft.

Outlook and valuations: Bullish commentary implies growth acceleration

After our Bay Area visit on 6th April, we had called out that the deal environment was [“Most bullish in a decade”](#) led by robust growth in digital and recovery in legacy deals. Our interactions with several technologists and sales personnel across the technology space almost unequivocally indicated significant demand revival and record-high deal-wins, which has started to play out. [In our view, further acceleration of revenue growth for Indian IT companies is on the cards. We maintain that the sector is poised for growth takeoff from ~6% in FY18 to double-digit levels over the next three years.](#)

Our bullish view was based on the US corporate profit recovery, increasing proportion of digital business, higher outsourcing momentum in Europe, and recovery in the key verticals, namely BFSI, Retail, Utilities and Communications. Our conviction is backed by positive Q4FY18 commentaries [\(V-shaped earnings spurt possible\)](#), EPAM’s and Luxoft’s better-than-expected results on the back of robust growth in BFSI [\(BFSI back with a bang\)](#), and Accenture’s highest upward guidance revision in the past five years [\(Most bullish in a decade – Conviction gets stronger\)](#).

QFY19: Key highlights

- Consolidated revenue at USD2,055mn grew 0.8% QoQ versus Street’s 2.0% QoQ estimate. In CC terms, revenue grew 2.7% QoQ. In INR terms, revenue rose 5.3% QoQ and 14.2% YoY to INR138.8bn.
- Gross profit stood at INR47.7bn, up 3.3% QoQ and 16.6% YoY. Gross margin at 34.4% was down 60bps QoQ. EBITDA stood at INR32.3bn with an EBITDA margin of 23.2% (up 20bps QoQ).
- Net profit grew 7.8% QoQ and 10.7% YoY to INR24.0bn.
- Net employees stood higher by 4,040, taking total headcount to 124,121. Gross addition for the quarter stood at 12,558.

Segmental performance

- **IT services:** The segment (contributes 94.8% to total revenue) grew 7.2% YoY (decline of 0.6% QoQ) to USD1,947mn versus USD1,959mn in the previous quarter. Operating margin (EBIT) rose 20bps QoQ to 20.1%.
- **Core software:** Revenue, at USD1,203mn, grew 0.4% QoQ and 10.4% YoY. Operating margin (EBIT), at 20.7%, rose 120bps QoQ.
- **IMS:** Revenue, at USD745mn, declined 2.1% QoQ and grew 2.4% YoY. EBIT margin declined 150bps QoQ to 19.2%.
- **BPO:** Revenue, at USD107.1mn, grew 36.4% QoQ and 60.2% YoY. EBIT margin rose 20bps QoQ to 11.1%.
- **Services:** Revenue growth was broadbased across services, i.e. business services (up 38.8% QoQ CC; majorly due to C3i acquisition) and ER&D services (up 3.1% QoQ CC). While Application services rose 0.8% QoQ, Infrastructure services rose 0.6% QoQ in CC.
- **Geo split:** In CC terms, growth was led by the Americas (up 5.9% QoQ) while Europe and RoW declined 1.0% and 7.1% QoQ, respectively.
- By vertical, growth was led by Lifesciences & Healthcare (up 13.4% QoQ) and Technology & Services (up 9.3% QoQ); Public services and TM&E grew 3.5% and 0.2% QoQ, respectively; Financial Services, Manufacturing and Retail-CPG declined 1.4%, 1.3% and 1.6% QoQ, respectively (on a CC basis).
- **Attrition** in IT services (LTM) stood at 16.3% versus 15.5% in the previous quarter.
- **Utilisation:** Blended utilisation stood at 85.5%, down 40bps QoQ.
- **DSO** stood at 66 days versus 65 in the previous quarter.

Financial snapshot

(INR mn)

Year to March	Q1FY19	Q4FY18	% Change	Q1FY18	% Change	FY18	FY19E	FY20E
Net revenues	138,780	131,790	5.3	121,490	14.2	505,700	590,159	668,763
Direct costs	91,070	85,600	6.4	80,570	13.0	332,370	384,597	436,938
Gross profit	47,710	46,190	3.3	40,920	16.6	173,330	205,563	231,825
SG&A	15,460	15,830	(2.3)	14,110	9.6	58,930	68,269	75,570
EBITDA	32,250	30,360	6.2	26,810	20.3	114,400	137,294	156,255
Depreciation	4,960	4,530	9.5	2,360	110.2	14,520	20,603	22,738
EBIT	27,290	25,830	5.7	24,450	11.6	99,880	116,691	133,517
Other income	1,530	1,190	28.6	1,620	(5.6)	5,700	5,462	6,346
Foreign exc. gain / (loss)	1,430	1,610	(11.2)	1,070	33.6	5,410	3,880	3,500
Profit before tax	30,250	28,630	5.7	27,140	11.5	110,990	126,033	143,363
Provision for taxes	6,220	6,340	(1.9)	5,430	14.5	23,170	27,775	32,362
Reported net profit	24,030	22,290	7.8	21,710	10.7	87,820	98,258	111,000
Adjusted Profit	24,030	22,290	7.8	21,710	10.7	87,820	98,258	111,000
Diluted EPS (INR)	17.3	16.0	7.8	15.1	14.0	62.6	71.9	81.2
Diluted P/E (x)	-	-	-	-	-	15.4	13.4	11.9
EV/EBITDA (x)	-	-	-	-	-	11.7	9.5	8.4
EV/Revenues (x)	-	-	-	-	-	2.6	2.2	2.0
Tax Rate	20.6	22.1	-	20.0	-	20.9	22.0	22.6

As % of net revenues

Gross profit	34.4	35.0	-	33.7	-	34.3	34.8	34.7
SG&A	11.1	12.0	-	11.6	-	11.7	11.6	11.3
EBITDA	23.2	23.0	-	22.1	-	22.6	23.3	23.4
EBIT	19.7	19.6	-	20.1	-	19.8	19.8	20.0
Reported net profit	17.3	16.9	-	17.9	-	17.4	16.6	16.6

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 124,121 and its revenues for the past twelve months stood at INR523.0bn (USD8.0bn).

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	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	26.1	26.0
Offshore (%)	74.0	73.9	73.9	74.0
Onsite (%)	(1.8)	2.0	1.9	-
Offshore (%)	(0.5)	2.0	1.9	-
BPO				
Revenue Growth (in USD)	(15.9)	5.5	3.3	(0.3)
Pricing Growth (%)	3.4	(2.9)	(2.6)	4.1
Cash yield (%)	7.0	7.0	7.0	7.2
Capex (INR mn)	(39,054)	(53,473)	(45,545)	(43,134)
Debtor days	84	83	80	78

Income statement

(INR mn)

Year to March	FY17	FY18	FY19E	FY20E
Net revenue	467,220	505,700	590,159	668,763
Cost of revenues	308,890	332,370	384,597	436,938
Gross profit	158,330	173,330	205,563	231,825
Total SG&A expenses	55,240	58,930	68,269	75,570
EBITDA	103,090	114,400	137,294	156,255
Depreciation	8,340	14,520	20,603	22,738
EBIT	94,750	99,880	116,691	133,517
Add: Other income	9,340.00	11,110.00	9,341.79	9,845.9
Profit Before Tax	104,090	110,990	126,033	143,363
Less: Provision for Tax	19,520	23,170	27,775	32,362
Reported Profit	84,570	87,820	98,258	111,000
Adjusted Profit	84,570	87,820	98,258	111,000
Shares o /s (mn)	1,413	1,404	1,366	1,367
Adjusted Basic EPS	59.9	62.6	71.9	81.2
Diluted shares o/s (mn)	1,413	1,404	1,366	1,367
Adjusted Diluted EPS	59.9	62.6	71.9	81.2
Adjusted Cash EPS	65.8	72.9	87.0	97.9
Dividend per share (DPS)	24.0	8.0	8.0	48.0
Dividend Payout Ratio(%)	46.9	14.9	13.0	51.7

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	11.6	11.3
EBITDA margins	22.1	22.6	23.3	23.4
EBIT margins	20.3	19.8	19.8	20.0
Net Profit margins	18.1	17.4	16.6	16.6

Growth ratios (%)

Year to March	FY17	FY18	FY19E	FY20E
Revenues	14.2	8.2	16.7	13.3
EBITDA	17.2	11.0	20.0	13.8
PBT	12.7	6.6	13.6	13.8
Adjusted Profit	15.0	3.8	11.9	13.0
EPS	15.1	4.5	15.0	12.9

Balance sheet		(INR mn)			
As on 31st March	FY17	FY18	FY19E	FY20E	
Share capital	2,827	2,784	2,712	2,714	
Reserves & Surplus	332,076	365,384	410,689	445,082	
Shareholders' funds	334,903	368,168	413,401	447,796	
Long term borrowings	5,417	4,371	2,830	1,830	
Total Borrowings	5,417	4,371	2,830	1,830	
Sources of funds	340,320	372,539	416,231	449,626	
Net Block	46,806	51,847	72,535	92,931	
Intangible Assets	114,256	144,057	155,570	155,570	
Total Fixed Assets	161,062	195,904	228,105	248,501	
Non current investments	115,119	86,060	91,140	91,140	
Cash and Equivalents	13,165	16,939	9,814	10,645	
Sundry Debtors	108,026	122,575	135,912	148,434	
Loans & Advances	66,950	62,873	77,880	88,264	
Current Assets (ex cash)	174,976	185,448	213,791	236,697	
Trade payable	124,002	111,812	126,619	137,356	
Total Current Liab	124,002	111,812	126,619	137,356	
Net Curr Assets-ex cash	50,974	73,636	87,173	99,341	
Uses of funds	340,320	372,539	416,231	449,626	
BVPS (INR)	237.1	262.2	302.7	327.6	

Profitability and efficiency ratios

Year to March	FY17	FY18	FY19E	FY20E
ROAE (%)	27.5	25.0	25.1	25.8
ROACE (%)	33.0	31.1	32.0	33.1
Debtors Days	84	83	80	78
Payable Days	137	129	113	110
Cash Conversion Cycle	(53)	(46)	(33)	(33)
Current Ratio	1.5	1.8	1.8	1.8

Peer comparison valuation

Name	Diluted P/E (X)		EV / EBITDA (X)		ROAE (%)	
	FY19E	FY20E	FY19E	FY20E	FY19E	FY20E
HCL Technologies	13.4	11.9	9.5	8.4	25.1	25.8
Cyient	16.8	14.0	10.5	9.0	18.9	20.0
ECLERX SERVICES	16.6	13.7	9.6	7.3	20.4	21.3
Hexaware Technologies	23.9	20.5	17.7	14.5	26.6	26.9
Infosys	18.7	16.7	13.4	11.8	27.0	32.0
L&T Infotech Ltd	22.6	19.1	17.2	13.7	34.9	34.4
L&T Technology Services Ltd	23.9	20.5	18.7	14.7	31.8	31.3
Persistent Systems	16.6	14.0	9.7	7.8	17.7	18.4
Tata Consultancy Services	24.3	22.0	18.4	16.3	35.9	39.7
Tech Mahindra	14.0	12.2	8.4	7.1	20.3	20.6
Wipro	14.8	13.3	11.9	10.7	16.6	17.5
Median	16.8	14.0	11.9	10.7	25.1	25.8
AVERAGE	18.7	16.2	13.2	11.0	25.0	26.2

Source: Edelweiss research

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	42.74	Hcl holdings pvt ltd	16.8
Artisan partners ltd	3.01	Icici prudential ass	1.77
Life insurance corp	1.6	Blackrock	1.57
Vanguard group	1.36	Icici prudential lif	1.08
Sbi funds management	0.96	Nomura	0.93

**in last one year*

Bulk Deals

Data	Acquired / Seller	B/S	Qty Traded	Price
05 Jun 2018	VAMA SUNDARI INVESTMENTS (DELHI) PRIVATE LIMITED	Buy	3200000	900.00
05 Jun 2018	Vama Sundari Investments (Delhi) Pvt Ltd	Buy	4300000	900.00
05 Jun 2018	HCL AVITAS PRIVATE LIMITED	Sell	3200000	900.00
05 Jun 2018	HCL CORPORATION PRIVATE LIMITED	Sell	4300000	900.00

**in last one year*

Insider Trades

Reporting Data	Acquired / Seller	B/S	Qty Traded
07 Jun 2018	Hcl Corporation Private Limited	Sell	4300000.00
07 Jun 2018	Hcl Avitas Private Limited	Sell	3200000.00
07 Jun 2018	Vama Sundari Investments (Delhi) Private Limited	Buy	7500000.00
28 Mar 2018	Rahul Singh	Sell	20000.00
01 Mar 2018	Anand Birje	Sell	16800.00

**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	BUY	SU	M	L&T Infotech Ltd	BUY	SO	M
L&T Technology Services Ltd	BUY	SO	M	Persistent Systems	BUY	SP	L
Redington India Ltd	BUY	SO	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

Edelweiss
Ideas create, values protect



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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, Redington India Ltd, Tata Consultancy Services, Tech Mahindra, Wipro

Recent Research

Date	Company	Title	Price (INR)	Recos
25-Jul-18	Hexaware Technologies	Revenue guidance raised, but valuations expensive; <i>Result Update</i>	456	Hold
24-Jul-18	Info Edge	Reviving IT hiring spurs Naukri; 99acres gaining ground; <i>Result Update</i>	1354	Buy
24-Jul-18	L&T Infotech	BFS drives outperformance; bullish stance exemplified; <i>Result Update</i>	1803	Buy

Distribution of Ratings / Market Cap

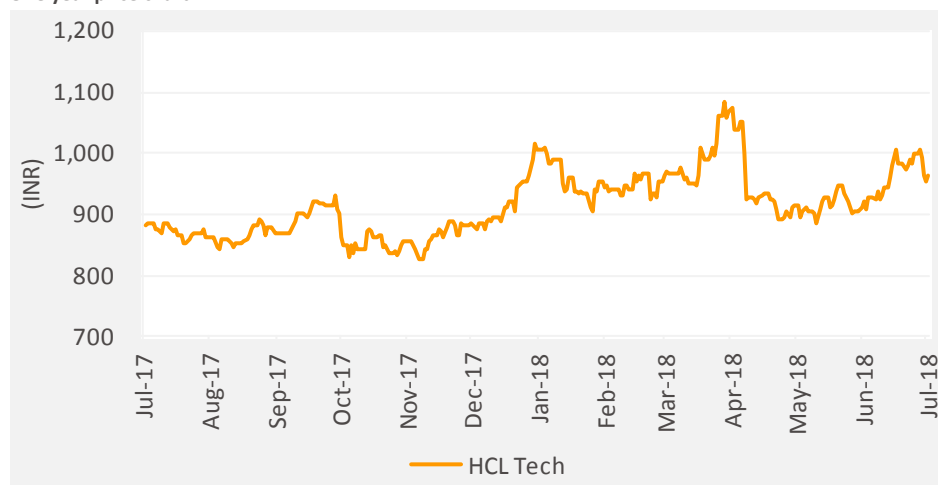
Edelweiss Research Coverage Universe

	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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