

Stock Update

Risky bet, downgrade to HOLD

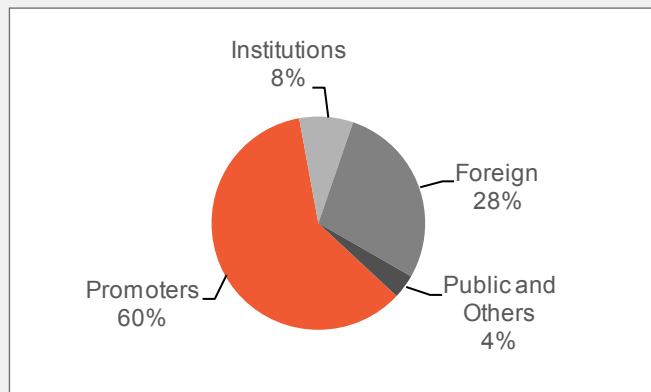
HCL Technologies

Reco: Hold | CMP: Rs962

Company details

Price target:	Rs1,050
Market cap:	Rs130,411 cr
52-week high/low:	Rs1,124/825
NSE volume: (No of shares)	21.9 lakh
BSE code:	532281
NSE code:	HCLTECH
Sharekhan code:	HCLTECH
Free float: (No of shares)	54.2 cr

Shareholding pattern



Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-1.6	-6.8	11.8	18.9
Relative to Sensex	-2.5	0.7	10.6	8.4

Key points

- ♦ **Event: To acquire select IBM products for \$1.8 billion:** HCL Technologies (HCL Tech) announced its largest acquisition ever in Indian IT industry with acquisition of seven IBM products for \$1,775 million including an earn out (~around Rs12500 crore). The addressable market of the acquired products is around \$50 billion. The transaction is expected to close by mid-2019. The seven products are primarily in three areas: (1) security – Appscan and BigFix, (2) marketing – Unica, Commerce, Portal and Notes & Domino and (3) collaboration – Connections. Out of seven acquired products, HCL Tech and IBM have ongoing partnership for five products and two products (Commerce and Connection) are totally new.
- ♦ **Funding structure:** Around 48% / \$852 million of the total deal will be paid at the close of the transaction (mid-2019 i.e June 2019) and the remaining amount of the purchase consideration will be paid after the end of a year. The acquisition will be financed largely through internal accruals and a debt of \$300 million at close of the deal. The company had net cash balance of \$1,170 million at the end of Q2FY2019 (excluding \$0.5 mn for buyback of shares, completed in October 2018).
- ♦ **Why we don't like the deal:** HCL Tech has already made significant investment of \$1.3 bn in IPs partnership in existing six IBM IP partnership and one with DXC and one with other with annualized revenues of \$360 mn of annual run rate, thus significant return on investment still remain elusive. With this deal, the company is taking the risks quotient to a much higher level that will increase the investors' concerns. We are putting out some of the concerns that we see in this deal.

(1) Out of seven products acquired, five are already under the existing IPs deal and only two products are new. Total combined market size growth of all products is around 10.9% and top four products in terms of size, growth is at 8.4%. Thus, we are not convinced with the logic of acquiring products having such low growth rate, rather than acquiring a new age digital technology companies, where the growth potential is almost three fold.

(2) The balance sheet will be turned cash rich to virtually zero cash, which will restrict the company to make any further relevant acquisition, without taking additional debts.

(3) HCL Tech does not have a strong product DNA. Thus, we see the risk of inefficient sale of these products with existing management bandwidth

(4) We assume that, these products are already sold to most of the high ticket enterprise customers by IBM, thus further penetration will be an uphill task.

(5) Management has indicated at dividend distribution of 50% of net income. However, we see risks on that given pressure in free cash flow generation and virtually zero cash balance sheet.

- ♦ **Incremental revenue remains strong, but uncertainty prevails:** The management highlighted that this acquisition would provide incremental revenue opportunity of \$625 million in the first years (\$25 million impact owing to transition) after the close of transaction (i.e June 2019) and \$650 million per annum from the second year onwards. On the margins front, the EBITDA margin is expected around 50% in the second year after the close of transaction

and a slightly lower EBITDA margin in the first year (owing to the transition and shifting of employees from IBM for the two new products). However, we believe that the large intangible assets could impact the profitability owing to higher amortization, where the management restricted itself to provide any kind of ballpark figure on allocation to intangibles and goodwill considering the complexity of the deal structure. Our back of envelope calculation suggests, taking a 25% goodwill for the deal and rest as intangibles, EPS accretion will be minimal at around 2-3%. We have kept our estimates unchanged as there is lesser clarity on goodwill and intangible arising out of the acquisition.

- ♦ **Downgrade to Hold with a revised price target of Rs. 1,050:** We believe the acquisition would further aggravate the investors' concerns on return on investments in products and IPs deals. Given the minimal earning accretion (based on our back of envelope calculation) coupled with less of clarity in future success of the acquisition and risks of lower dividend payout will restrict any re-rating on the stock. We have reduced our target multiple on HCL Tech to 13x from 15x earlier in factoring the risks of this acquisition. Accordingly, we have downgraded stock to HOLD from BUY with a revised target price of Rs1050.

Valuation

Particulars	FY18	FY19E	FY20E	Rs cr FY21E
Net sales	50,570.0	60,405.3	67,140.1	71,549.5
EBITDA margin (%)	22.6	23.3	23.3	23.1
Net profit	8,780.0	9,996.4	10,958.9	11,534.1
EPS (Rs.)	63.1	72.7	80.8	85.0
P/E (x)	4.1	3.6	3.2	3.1
EV/EBITDA (x)	2.9	2.3	2.1	2.0
RoE (%)	25.3	25.5	24.3	22.7
RoCE (%)	30.0	30.6	29.7	27.9

*we have not incorporated acquisitions impact in our estimates given lesser clarity on goodwill and intangible arising out of the acquisition

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