

# HCL Technologies (HCLTEC)

₹ 960

## To acquire IBM products for \$1.8 billion...

HCL Technologies (HCLT) has signed a definitive agreement to acquire select IBM software products for \$1.8 billion. The HCLT management expects incremental revenue of \$625 million in the first year and \$650 million in the second year after deal closure. The EBITDA margin of the acquired products is expected to be ~50% with cash EPS accretive by 15%. The transaction is expected to be closed by mid-2019 subject to completion of applicable regulatory reviews. Our key concern in the transaction is around sustenance of margins at 50% (post acquisition), risk of revenues from IP products not fully materialising, lower focus on organic growth and near term pressure on cash flows. Hence, we downgrade the stock from BUY to HOLD.

### HCLT-IBM \$1.8 billion deal...

In its biggest acquisition amounting to US\$1.8 billion including earn-out, HCLT would acquire seven IBM software products ranging from security management, enterprise collaboration, digital experience and ecommerce. As per the management, software products in scope represent a total addressable market of more than \$50 billion and would enhance client interactions and cross-selling opportunities. Looking from the perspective of financial transactions, ~48% of the consideration (\$1.8 billion) is to be paid at the closure of the deal (expected mid-2019) while most of the remaining balance (52%) is to be paid after the first year post deal closure (estimated mid-2020). Further, the investment would be funded through a debt of \$300 million at close and internal accruals. Cash and cash equivalents were at US\$1,594 million at the end of Q2FY19. From the viewpoint of revenue accretion, the HCLT management expects incremental revenue of \$625 million in the first year and \$650 million on a run rate basis in the second year after deal closure. As per the management, the EBITDA margin of the acquired products is expected to be ~50% on a run rate basis and cash EPS accretive by 15%.

### Sceptical about growth driven by acquisitions...

Out of the seven products acquired by the company, it already has a partnership in five products for which the company has invested \$800 million taking the total investment to \$2.6 billion. We believe this huge investment puts pressure on the company's cash flow and adds debt to the balance sheet. Further, considering the volatile nature of IP revenues, it could also cast a shadow of doubt on revenue growth as well as margin sustenance at current level. Adding this acquisition in its portfolio, going ahead, the split of organic and inorganic growth would shift more towards the latter, implying a weaker organic growth trajectory. Moreover, if the deal does not ramp up as per expectations it could act as a downside risk to profitability. We are not incorporating the acquisition into our estimates as of now on account of awaited regulatory reviews.

### Near term concerns prompt us to downgrade to HOLD...

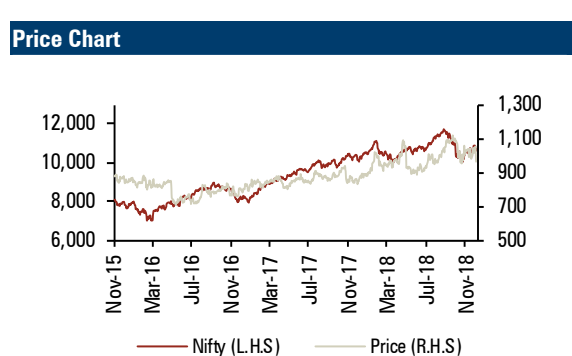
We believe HCLT's continuous investments in IP and acquisitions could mount pressure on its profitability on account of the volatile nature of IP business and slow ramp of revenues through acquisitions. Hence, we lower our valuation multiple to 13x FY20E EPS (earlier ~14x) owing to a dim view on organic growth and scepticism around sustenance of revenues & margins in acquired assets along with near term pressure on cash flows. Hence, we have a **HOLD** recommendation on the stock with a revised target price of ₹ 1045 per share.

Rating matrix	
Rating	: Hold
Target	: ₹ 1045
Target Period	: 12 months
Potential Upside	: 9%

What's Changed?	
Target	Changed from ₹ 1090 to ₹ 1045
EPS FY19E	Unchanged
EPS FY20E	Unchanged
Rating	Changed from Buy to Hold

Key Financials				
₹ Crore	FY17	FY18	FY19E	FY20E
Net Sales	46,723	50,570	60,648	66,856
EBITDA	9,474	9,987	12,130	13,371
Net Profit	8,457	8,780	10,131	10,909
EPS (₹)	60.0	62.6	74.7	80.5

Valuation summary				
	FY17	FY18	FY19E	FY20E
P/E	16.0	15.3	12.8	11.9
Target P/E	17.4	16.7	14.0	13.0
EV / EBITDA	13.0	11.5	9.1	7.9
P/BV	4.0	3.7	3.4	3.0
RoNW (%)	25.3	23.8	26.5	24.8
RoCE (%)	29.0	27.4	32.0	31.0



**Research Analyst**  
 Devang Bhatt  
 devang.bhatt@icicisecurities.com  
 Deepti Tayal  
 deepti.tayal@icicisecurities.com

## Financial summary

Profit and loss statement		₹ Crore			
	FY17	FY18	FY19E	FY20E	
Total operating Income	46,723	50,570	60,648	66,856	
Growth (%)	14.2	8.2	19.9	10.2	
Direct costs	30,890	33,237	39,239	43,256	
S,G&A expenses	5,524	5,894	7,096	7,822	
Total Operating Expenditure	36,414	39,131	46,335	51,078	
EBITDA	10,309	11,440	14,313	15,778	
Growth (%)	17.2	11.0	25.1	10.2	
Depreciation	771	1,453	2,183	2,407	
Amortisation	64	-	-	-	
Other Income	746	570	647	797	
PBT	10,220	10,557	12,776	14,168	
Forex adjustments	-	-	-	-	
Total Tax	1,952	2,316	2,857	3,259	
PAT	8,457	8,780	10,131	10,909	
Growth (%)	15.0	3.8	15.4	7.7	
EPS (₹)	60.0	62.6	74.7	80.5	
Growth (%)	15.2	4.3	19.4	7.7	

Source: Company, ICICI Direct Research

Cash flow statement		₹ Crore			
	FY17	FY18	FY19E	FY20E	
PBT	10,220	10,557	12,776	14,168	
Depreciation & Amortisation	835	1,453	2,183	2,407	
(Inc)/dec in Current Assets	(653)	(992)	(2,800)	(1,799)	
Inc/(dec) in CL and Provisions	1,639	(1,233)	1,976	1,217	
Taxes paid	(1,952)	(2,316)	(2,857)	(3,259)	
CF from operating activities	9,532	7,440	10,843	11,937	
(Inc)/dec in Investments	746	570	647	797	
(Inc)/dec in Fixed Assets	(1,168)	(1,264)	(1,516)	(1,671)	
CF from investing activities	(422)	(694)	(870)	(875)	
Issue/(Buy back) of Equity	-	(3,500)	(4,000)	-	
Inc/(dec) in loan funds	(69)	-	-	-	
Dividend paid & dividend tax	(3,972)	(1,955)	(4,741)	(5,106)	
Inc/(dec) in debentures	-	-	-	-	
Others	-	-	-	-	
CF from financing activities	(4,040)	(5,455)	(8,741)	(5,106)	
Net Cash flow	5,069	1,291	1,232	5,957	
Exchange difference	-	-	-	-	
Opening Cash	729	1,317	1,694	2,926	
Bank bal + unclaimed dvd.	(4,482)	-	-	-	
Cash c/f to balance sheet	1,317	1,694	2,926	8,883	

Source: Company, ICICI Direct Research

Balance sheet		₹ Crore			
	FY17	FY18	FY19E	FY20E	
Liabilities					
Equity Capital	283	278	271	271	
Reserve and Surplus	33,208	36,538	37,935	43,739	
Total Shareholders funds	33,490	36,817	38,206	44,010	
Total Debt	542	437	437	437	
Other liabilities + Provisions	1,253	1,267	1,267	1,267	
Minority Interest / Others	-	-	-	-	
Total Liabilities	35,285	38,521	39,910	45,714	
Assets					
Net Block+ CWIP	4,681	5,185	4,518	3,782	
Intangible assets	11,426	14,406	14,406	14,406	
Investments	10,366	6,249	6,249	6,249	
Liquid investments	1,146	2,357	2,357	2,357	
Inventory	-	-	-	-	
Debtors	10,803	12,258	14,556	16,046	
Loans and Advances	-	-	-	-	
Other Current Assets	2,983	2,520	3,022	3,331	
Cash	1,317	1,694	2,926	8,883	
Total Current Assets	16,248	18,828	22,861	30,617	
Total Current Liabilities	11,148	9,914	11,890	13,107	
Net Current Assets	5,100	8,914	10,971	17,510	
Other non current assets	3,712	3,768	3,768	3,768	
Application of Funds	35,285	38,521	39,910	45,714	

Source: Company, ICICI Direct Research

Key ratios		FY17				FY18				FY19E				FY20E			
Per share data (₹)																	
EPS		60.0	62.6	74.7	80.5												
Cash EPS		65.9	73.0	90.8	98.2												
BV		237.6	262.5	281.8	324.6												
DPS		24.0	12.0	35.0	37.7												
Cash Per Share		9.3	12.1	21.6	65.5												
Operating Ratios (%)																	
EBIT Margin		20.3	19.7	20.0	20.0												
PBT Margin		21.9	20.9	21.1	21.2												
PAT Margin		18.1	17.4	16.7	16.3												
Debtor days		84	88	88	88												
Creditor days		-	-	-	-												
Return Ratios (%)																	
RoE		25.3	23.8	26.5	24.8												
RoCE		29.0	27.4	32.0	31.0												
RoIC		28.9	29.0	35.0	38.8												
Valuation Ratios (x)																	
P/E		16.0	15.3	12.8	11.9												
EV / EBITDA		13.0	11.5	9.1	7.9												
EV / Net Sales		2.9	2.6	2.2	1.9												
Market Cap / Sales		2.9	2.7	2.2	2.0												
Price to Book Value		4.0	3.7	3.4	3.0												
Solvency Ratios																	
Debt/EBITDA		0.1	0.0	0.0	0.0												
Debt / Equity		0.0	0.0	0.0	0.0												
Current Ratio		1.2	1.5	1.5	1.5												
Quick Ratio		1.2	1.5	1.5	1.5												

Source: Company, ICICI Direct Research

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Buy: > 10%/15% for large caps/midcaps, respectively;

Hold: Up to +/-10%;

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**Pankaj Pandey**

**Head – Research**

**pankaj.pandey@icicisecurities.com**

**ICICI Direct Research Desk,  
ICICI Securities Limited,  
1st Floor, Akruiti Trade Centre,  
Road No 7, MIDC,  
Andheri (East)  
Mumbai – 400 093  
[research@icicidirect.com](mailto:research@icicidirect.com)**

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