

Robust revenue growth, margins disappoint

HCL Tech reported healthy revenue growth of 3.3% QoQ in constant currency on the back of healthy growth in organic revenues. Growth was broad based across geographies. Among services, infrastructure services (38.9% of revenues) registered healthy growth on the back of deal ramp ups. This growth momentum is expected to continue ahead. However, EBIT margin declined 65 bps in Q4FY19 mainly due to rupee appreciation (impact of 40 bps) and seasonal weakness in products & platform revenues.

Despite healthy deal pipeline, organic growth not catching up

The company expects growth in the near term to be driven by digital business while macroeconomic issues may impact legacy business. Hence, the company expects its Mode 1 (its traditional business) business to grow in low single digit and Mode 2/Mode 3 (new age businesses) to grow from the current 28.4% to 35.0% of overall revenues by FY21E. Further, the company's qualified pipeline is 10% higher than FY19 pipeline. This has led the company to give guidance of 14-16% of which 7-9% will be through organic growth (PY organic growth was 6.5%) while 7% growth will be inorganic (led by acquisition of IBM products, H&D international, Actian and Strong Bridge Envision). However, considering the robust deal wins by the company in the previous quarters, we believe the organic guidance (that will be more back ended) is disappointing. This may be due to pressure in legacy business. Hence, we conservatively build in revenue growth of 15.0% for FY20E, 10.8% for FY21E leading to revenue CAGR of 12.9% in FY19-21E.

High transition cost, increased investment to dent margins

HCL Technologies has revised its EBIT margin guidance to 18.5-19.5% in FY20E. This is 1% lower than the earlier guided range. The downward revision in guidance is due to higher investment in resources for IBM deal, cost pressure due to wage hike and attrition, higher investment in digital services and transition cost for large deals. Hence, we expect FY20E margins at 18.9% and FY21E to be at 19.0%. Further, the company is expected to incur hedging cost of US\$30 million to hedge its payment liability of US\$900 million to IBM, which will dent its FY20E EPS.

Valuation & Outlook

Although the company is expected to report healthy growth in revenues, its margins are expected to be under pressure led by an increase in employee cost, large deal transition cost and acquisition related cost. Further, incremental hedging cost in FY20E will dent EPS. This coupled with recent run up in stock prompts us to maintain our **HOLD** recommendation with a revised target price of ₹ 1190/share (~14x FY21E EPS).

HCL

Particulars

Particular	Amount
Market Capitalization (₹ Crore)	146,833.1
Total Debt (FY19) (₹ Crore)	3,701.0
Cash & Equivalents (₹ Crore)	10,092.2
EV (₹ Crore)	143,219.1
52 week H/L	1190 / 880
Equity capital	271.2
Face value	₹ 2

Key Highlights

- Guides revenue growth of 14-16% in FY20E
- EBITDA margins to be lower in FY20E mainly due to higher investment in digital business and large deal transition cost
- Maintain **HOLD** recommendation with revised target price of ₹ 1190

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Key Financial Summary

Key Financials	FY17	FY18	FY19	FY20E	FY21E	FY(19-21E)
Net Sales	46,723	50,570	60,427	69,502	76,980	12.9%
EBITDA	10,309	11,440	13,968	15,916	17,705	12.6%
Margins (%)	22.1	22.6	23.1	22.9	23.0	
Net Profit	8,457	8,780	10,122	10,398	11,570	6.9%
EPS (₹)	60.0	62.6	74.7	76.7	85.3	
P/E	18.1	17.3	14.5	14.1	12.7	
RoNW (%)	25.3	23.8	24.5	22.5	22.3	
RoCE (%)	29.0	27.4	26.5	26.0	25.9	

Source: Company, ICICI Direct Research

Exhibit 1: Variance Analysis

	Q4FY19	Q4FY19E	Q4FY18	YoY (%)	Q3FY19	QoQ (%)	Comments
Revenue	15,990	15,899	13,179	21.3	15,699	1.9	Revenues in constant currency grew strongly by 3.3% mainly led by healthy growth in Mode 1 and Mode 2 revenues
Cost of sales (including employee expenses)	10,421	10,286	8,560	21.7	10,152	2.6	
Gross Margin	5,569	5,612	4,619	20.6	5,547	0.4	
Gross margin (%)	34.8	35.3	35.0	-22 bps	35.3	-51 bps	
Selling & marketing costs	1,972	1,908	1,583	24.6	1,900	3.8	
EBITDA	3,597	3,704	3,036	18.5	3,647	-1.4	
EBITDA Margin (%)	22.5	23.3	23.0	-54 bps	23.2	-74 bps	
Depreciation	558	572	453	23.2	561	-0.5	
EBIT	3,039	3,132	2,583	17.7	3,086	-1.5	
EBIT Margin (%)	19.0	19.7	19.6	-59 bps	19.7	-65 bps	EBIT margins declined 65 bps mainly led by 40 bps impact of rupee appreciation with the rest due to a decline in product margins
Other income	152	174	280	-45.7	105	44.8	
PBT	3,191	3,306	2,863	11.5	3,191	0.0	
Tax paid	615	727	634	-3.0	566	8.7	
PAT	2,568	2,579	2,227	15.3	2,611	-1.6	PAT declined 1.6% QoQ mainly led by poor operating performance

Source: Company, ICICI Direct Research

Exhibit 2: Change in estimates

	FY19		FY20E		FY21E			
(₹ Crore)	Current	Old	New	% Change	Old	New	% Change	Comments
Revenue	60,427	66,954	69,502	3.8	72,659	76,980	5.9	We revise our revenue estimate to incorporate IBM product revenues and acquisitions
EBIT	11,820	13,190	13,136	-0.4	14,314	14,626	2.2	
EBIT Margin (%)	19.6	19.7	18.9	-80 bps	19.7	19.0	-70 bps	Margin estimates revised downwards mainly led by higher transition cost of large deals and impact of integration of IBM deal
PAT	10,122	10,860	10,398	-4.2	11,835	11,570	-2.2	
EPS (₹)	74.7	80.1	76.7	-4.2	87.3	85.3	-2.2	

Source: Company, ICICI Direct Research

Conference Call Highlights

- Revenue outlook** - The company indicated that its qualified pipeline is 10% higher than FY19 and expects growth to be driven by digital technologies. Based on this, the company has guided revenue growth of 14-16% of which 7-9% will be through organic growth (FY organic growth was 6.5%) and 7% growth will be inorganic (led by acquisition of IBM products, H&D international, Actian and Strong Bridge Envision). If we consider midpoint of guidance for organic growth i.e. 8%, it will be 1.5% higher than the organic growth in FY19. Considering the robust deal wins by the company in the previous quarters, we believe the organic guidance (that will be more back ended) is disappointing. We believe this may be due to anticipated slowdown in macroeconomic condition and pressure in legacy business (that the company indicated will be higher in poor macro conditions)
- Downgrades EBIT margin guidance**- HCL Technologies has revised its EBIT margin guidance to 18.5-19.5% in FY20E. This is 1% lower than the earlier guided range. The downward revision in guidance is due to higher investment in resources for IBM deal, cost pressure due to wage hike and attrition, higher investment in digital services and transition cost for large deals. The Q1FY20E margins will be lower than guided range due to above highlighted cost pressures. We believe this lower margin in Q1FY20E will impact FY20E margins.
- IMS to continue growth**- IMS (38.9% of revenue), the largest contributor to revenue by service mix posted a strong growth of 7.3% QoQ and 21.9% YoY on the back of pick up in deals and on a higher base in Q3FY19. Large deal wins is expected to support IMS revenue growth in coming years.
- Financial Services**- Comprising 21.1% of revenues, revenues from the vertical posted another muted show and increased marginally by 0.9 % QoQ in CC terms. The vertical continues to see softness due to client specific headwinds in two large accounts in Europe. However, it said it sees good momentum outside certain clients in Europe and expects the vertical to be muted in FY20E. The company expects manufacturing to post better growth in coming quarters
- Good deal signings**- The company signed 17 transformational deals during the quarter for another straight quarter driven by Retail & Consumer Packaged Goods, Manufacturing, Public Services and Financial Services. Total 78 transformational deals have been signed in FY19. The company indicated that its qualified pipeline is 10% higher than FY19
- Mode 2 and 3 witness healthy growth**- Mode 2 (digital business) and mode 3 (product business), which are into newer age technologies together constituted 29.5% of revenues. While Mode 2 revenues increased 14.3% QoQ, Mode 3 revenues declined 7.6% QoQ due to seasonal weakness. The company plans to increase Mode 2 and Mode 3 revenues to 35% by FY21E from 28.4% in FY19. The IBM products acquisition will be reflected in Mode 3 business. In terms of margins, Mode 2 margins improved 80 bps QoQ while Mode 3 margins declined 420 bps. Going forward, the company has indicated that Mode 2 margins will be under pressure due to higher investment in improving digital capability and Mode 3 margins will be higher than existing 22.8% mainly due to consolidation of IBM products in this segment

- **Change in segmental reporting** – The company indicated that going forward it will report segment as follows 1) products and platform 2) ERS and 3) Business IT services.
- **Acquisition of IBM products**- In December 2018, HCL has signed a definitive agreement to acquire select IBM software products for \$1.8 billion. The process is expected to be completed by May 2019. The company will be incorporating one month of revenues in Q1FY20E but expenses will be accounted for entire quarter, which will dent Q1FY20E margins. The margins are expected to improve in coming quarters
- **Employee update**- The employee count was at 137,965. On the attrition front, IT services attrition was flat QoQ at 17.7% (LTM). Blended utilisation (including trainees) declined 120 bps sequentially to 85.4%

Key Metrics

Exhibit 3: Geography wise split up

	Q3FY18	Q4FY18	Q1FY19	Q2FY19	Q3FY19	Q4FY19
Revenue by geography (%)						
Americas	63.5	61.6	64.5	65.8	64.4	62.9
Europe	28.7	30.0	28.1	26.8	28.2	29.7
RoW	7.9	8.5	7.5	7.4	7.3	7.4
Growth QoQ (%) - Constant Currency						
Americas	4.9	-0.7	5.9	4.4	2.7	1.1
Europe	1.9	3.6	-1.0	-0.9	12.9	8.4
RoW	-3.9	8.1	-7.1	4.9	4.5	3.6

Source: Company, ICICI Direct Research

Growth was broad based across geographies

Exhibit 4: Industry wise break-up

	Q3FY18	Q4FY18	Q1FY19	Q2FY19	Q3FY19	Q4FY19
Revenue by verticals (%)						
Financial Services	24.6	25.0	23.8	23.0	21.6	21.1
Manufacturing	36.5	36.0	18.3	18.0	17.7	17.5
Lifesciences & Healthcare	11.7	11.5	12.8	12.9	13.0	13.0
Public Services	10.2	10.6	10.5	10.7	9.7	11.1
Retail & CPG	9.6	9.6	9.1	10.0	10.2	10.0
Telecommunications, Media, Publishing & Entertainment	7.4	7.4	7.3	7.2	9.2	8.6
Growth QoQ (%) - Constant currency						
Financial Services	1.4	2.0	-1.4	0.1	-0.6	0.9
Manufacturing	6.6	0.2	-1.3	1.7	3.9	2.5
Lifesciences & Healthcare	2.4	-0.2	13.4	3.2	5.8	3.5
Public Services	0.2	4.1	3.5	5.3	-4.4	17.7
Retail & CPG	6.6	1.1	-1.6	13.0	8.4	1.4
Telecommunications, Media, Publishing & Entertainment	-3.8	1.8	0.2	1.1	35.4	-3.8

Source: Company, ICICI Direct Research

Financial services was muted mainly due to challenges in two of its clients located in European region

Exhibit 5: Segment offering wise break-up

	Q3FY18	Q4FY18	Q1FY19	Q2FY19	Q3FY19	Q4FY19
Revenue by services (%)						
Application Services	35.3	34.7	34.0	33.1	32.0	32.6
Infrastructure Services	36.7	37.3	36.2	36.0	37.5	38.9
Business Services	3.7	3.9	5.2	5.4	5.0	4.5
Engineering and R&D Services	24.2	24.1	24.5	25.5	25.5	23.9
Growth QoQ (%) - Constant currency						
Application Services	1.6	-0.9	0.8	0.4	2.3	5.2
Infrastructure Services	-1.2	2.5	0.6	2.5	10.4	7.3
Business Services	5.0	5.3	38.8	7.3	-3.7	-5.8
Engineering and R&D Services	13.6	1.7	3.1	6.3	5.1	-3.0

Source: Company, ICICI Direct Research

Application services and IMS registered healthy growth in the quarter

Exhibit 6: Client & human resource matrix

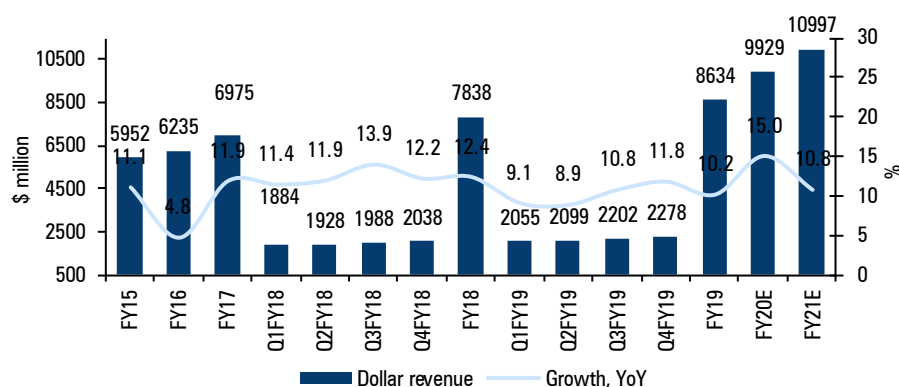
	Q3FY18	Q4FY18	Q1FY19	Q2FY19	Q3FY19	Q4FY19
<u>Client metrics</u>						
US\$1-5 million	291	297	304	306	321	340
US\$10-20 million	71	73	75	75	69	71
US\$50-100 million	16	20	23	22	19	19
US\$100 million+	9	8	9	9	10	10
<u>Headcount, Utilization & Attrition</u>						
Total Employees	119,291	120,081	124,121	127,875	132,328	137,965
Blended Utilization (In- trainees)	85.8	85.9	85.5	86.7	86.6	85.4
Attrition - IT Services (LTM)	15.2	15.5	16.3	17.1	17.8	17.7

Source: Company, ICICI Direct Research

Addition was mainly in US\$1-5 million bucket

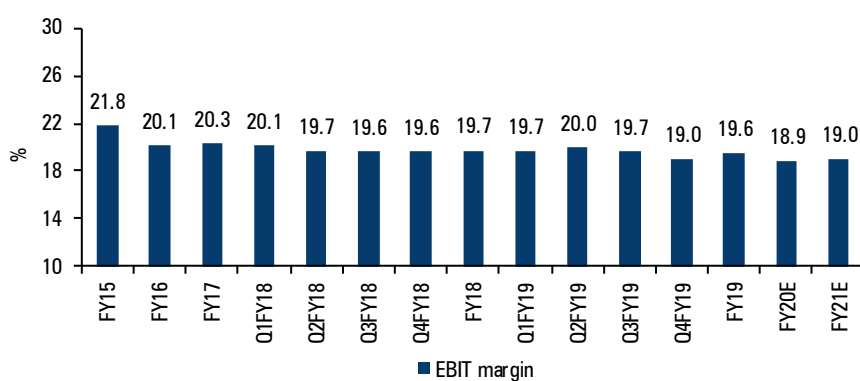
Financial story in charts

Exhibit 7: Dollar revenues may grow at 12.9% CAGR in FY19-21E



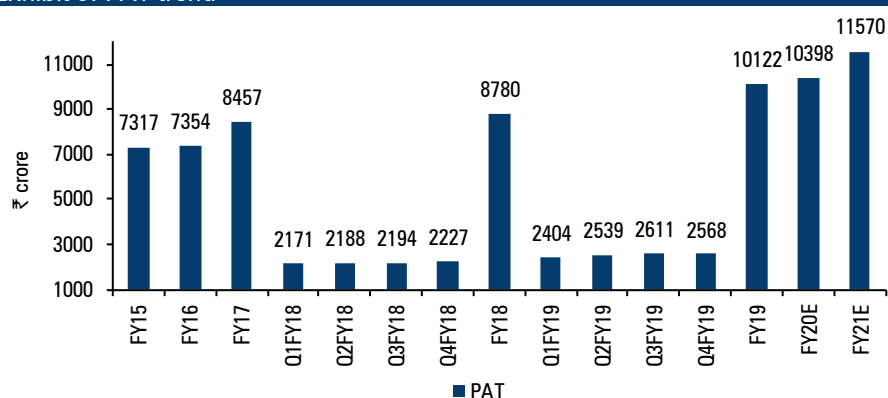
Source: Company, ICICI Direct Research

Exhibit 8: Revise our margin estimates downwards



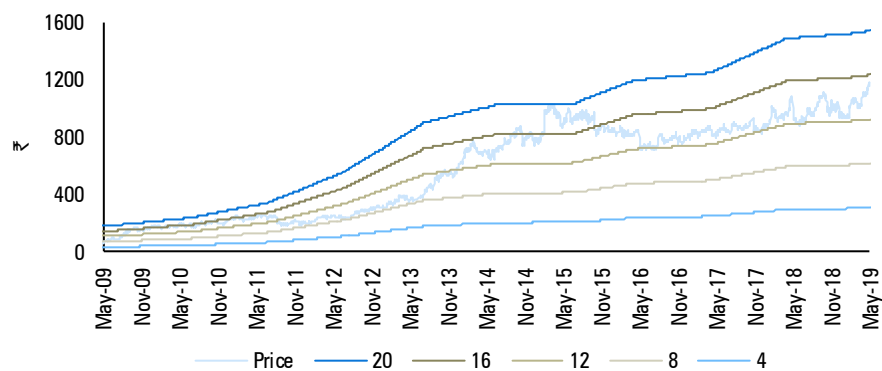
Source: Company, ICICI Direct Research

Exhibit 9: PAT trend



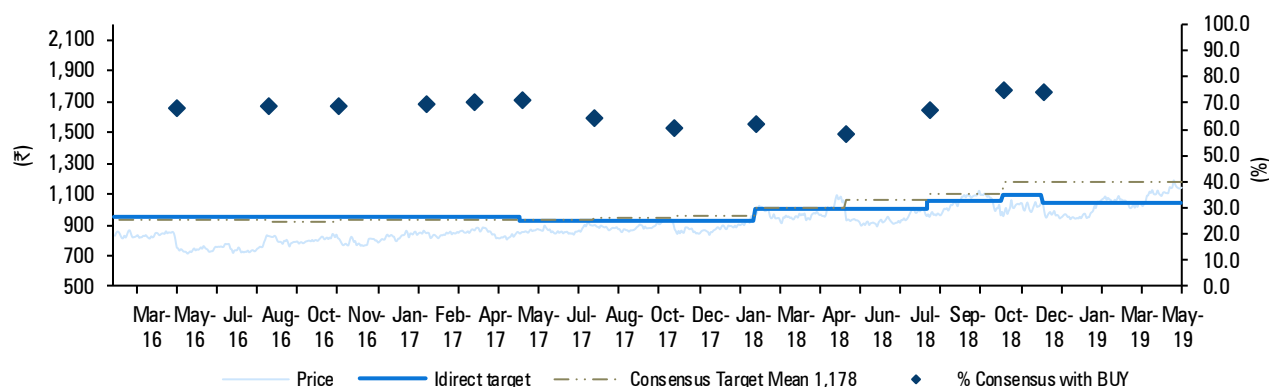
Source: Company, ICICI Direct Research

Exhibit 10: One year forward rolling price to earnings



Source: Company, ICICI Direct Research

Exhibit 11: Recommendation History vs. Consensus



Source: Bloomberg, Company, ICICI Direct Research

Exhibit 12: Top 10 Shareholders

Rank	Name	Latest Filing Date	% O/S	Position (m)	Change (m)
1	Vamasundari Investments (Delhi) Pvt. Ltd.	31-Mar-19	42.9%	581.9	0.0
2	HCL Holdings Pvt. Ltd.	31-Mar-19	16.5%	223.3	0.0
3	Artisan Partners Limited Partnership	31-Mar-19	1.5%	20.8	-0.2
4	BlackRock Institutional Trust Company, N.A.	30-Apr-19	1.5%	20.0	0.0
5	The Vanguard Group, Inc.	31-Mar-19	1.4%	19.3	-0.3
6	Vontobel Asset Management, Inc.	31-Mar-19	1.3%	17.3	-0.1
7	SBI Funds Management Pvt. Ltd.	31-Mar-19	1.1%	15.4	0.7
8	Life Insurance Corporation of India	31-Mar-19	1.1%	15.1	-3.4
9	ICICI Prudential Asset Management Co. Ltd.	31-Mar-19	1.1%	14.9	0.0
10	Aditya Birla Sun Life AMC Limited	31-Mar-19	0.8%	10.8	-0.2

Source: Reuters, ICICI Direct Research

Exhibit 13: Recent Activity

Buys			Sells		
Investor name	Value	Shares	Investor name	Value	Shares
RBC Investment Management (Asia) Ltd.	20.17m	1.36m	Life Insurance Corporation of India	-53.78m	-3.42m
Norges Bank Investment Management (NBIM)	12.16m	0.88m	DNB Asset Management AS	-9.85m	-0.70m
Origin Asset Management LLP	11.73m	0.75m	Reliance Nippon Life Asset Management Limited	-10.37m	-0.66m
Caisse de Depot et Placement du Quebec	9.62m	0.69m	BNP Paribas Asset Management Asia Limited	-5.75m	-0.42m
SBI Funds Management Pvt. Ltd.	10.38m	0.66m	Schroder Investment Management (Hong Kong) Ltd.	-4.43m	-0.31m

Source: Reuters, ICICI Direct Research

Exhibit 14: Shareholding Pattern

(in %)	Sep-18	Dec-18	Mar-19
Promoter	60.17	60.00	60.00
Public	39.83	40.00	40.00
Others	0.00	0.00	0.00
Total	100.00	100.00	100.00

Source: Company, ICICI Direct Research

Financial summary

Exhibit 15: Profit and loss statement ₹ crore				
	FY18	FY19	FY20E	FY21E
Total operating Income	50,570	60,427	69,502	76,980
Growth (%)	8.2	19.5	15.0	10.8
Direct costs	33,237	39,268	45,315	50,114
S,G&A expenses	5,894	7,191	8,271	9,161
Total Operating Expenditure	39,131	46,459	53,586	59,274
EBITDA	11,440	13,968	15,916	17,705
Growth (%)	11.0	22.1	13.9	11.2
Depreciation	1,453	2,148	2,780	3,079
Amortisation	-	-	-	-
Other Income	570	624	371	242
PBT	10,557	12,444	13,506	14,868
Forex adjustments	-	-	-	-
Total Tax	2,316	2,481	2,933	3,263
PAT	8,780	10,122	10,398	11,570
Growth (%)	3.8	15.3	2.7	11.3
EPS (₹)	62.6	74.7	76.7	85.3
Growth (%)	4.3	19.3	2.7	11.3

Source: Company, ICICI Direct Research

Exhibit 16: Cash flow statement ₹ crore				
	FY18	FY19*	FY20E	FY21E
PBT	10,557	12,444	13,506	14,868
Depreciation & Amortisation	1,453	2,148	2,780	3,079
(Inc)/dec in Current Assets	(1,047)	(6,375)	(6,060)	(2,764)
Inc/(dec) in CL and Provisions	(1,219)	2,224	8,199	(5,029)
Taxes paid	(2,316)	(2,503)	(2,933)	(3,263)
CF from operating activities	7,399	7,495	15,123	6,649
(Inc)/dec in Investments	3,476	6,570	196	207
(Inc)/dec in Fixed Assets	(4,937)	(5,681)	(8,199)	(1,924)
CF from investing activities	(1,461)	889	(13,967)	(1,718)
Issue/(Buy back) of Equity	(3,499)	(4,201)	-	-
Inc/(dec) in loan funds	(105)	3,264	-	-
Dividend paid & dividend tax	(1,955)	(1,269)	(5,475)	(6,091)
Inc/(dec) in debentures	-	-	-	-
Others	-	-	-	-
CF from financing activities	(5,558)	(2,206)	(5,475)	(6,091)
Net Cash flow	379	6,178	(4,319)	(1,160)
Exchange difference	-	-	-	-
Opening Cash	1,317	1,694	7,872	3,553
Bank bal + unclaimed dvd.	-	-	-	-
Cash c/f to balance sheet	1,694	7,872	3,553	2,393

*calculated; Source: Company, ICICI Direct Research, * calculated

Exhibit 17: Balance sheet ₹ crore				
	FY18	FY19	FY20E	FY21E
Liabilities				
Equity Capital	278	271	271	271
Reserve and Surplus	36,538	41,095	46,019	51,497
Total Shareholders funds	36,817	41,366	46,290	51,768
Total Debt	437	3,701	3,701	3,701
Other liabilities + Provisions	1,267	1,830	1,830	1,830
Minority Interest / Others	-	103	103	103
Total Liabilities	38,521	47,000	51,924	57,402
Assets				
Net Block + CWIP	5,185	5,528	16,910	15,756
Intangible assets	14,406	17,595	17,595	17,595
Investments	6,249	440	440	440
Liquid investments	2,357	2,220	2,220	2,220
Inventory	-	-	-	-
Debtors	12,258	11,797	16,680	18,475
Loans and Advances	-	-	-	-
Other Current Assets	2,520	7,833	9,009	9,979
Cash	1,694	7,872	3,553	2,393
Total Current Assets	18,828	29,722	31,463	33,067
Total Current Liabilities	9,914	11,575	19,774	14,746
Net Current Assets	8,914	18,147	11,688	18,321
Other non current assets	3,768	5,290	5,290	5,290
Application of Funds	38,521	47,000	51,924	57,402

Source: Company, ICICI Direct Research

Exhibit 18: Key ratios ₹ crore				
	FY18	FY19	FY20E	FY21E
Per share data (₹)				
EPS	62.6	74.7	76.7	85.3
Cash EPS	73.0	90.5	97.2	108.0
BV	262.5	305.1	341.4	381.8
DPS	12.0	8.0	40.4	44.9
Cash Per Share	12.1	58.1	26.2	17.7
Operating Ratios (%)				
EBIT Margin	19.7	19.6	18.9	19.0
PBT Margin	20.9	20.6	19.4	19.3
PAT Margin	17.4	16.8	15.0	15.0
Debtor days	88	71	88	88
Return Ratios (%)				
RoE	23.8	24.5	22.5	22.3
RoCE	27.4	26.5	26.0	25.9
RoIC	29.0	32.0	28.5	27.7
Valuation Ratios (x)				
P/E	17.3	14.5	14.1	12.7
EV / EBITDA	12.5	10.1	9.1	8.2
EV / Net Sales	2.8	2.3	2.1	1.9
Market Cap / Sales	2.9	2.4	2.1	1.9
Price to Book Value	4.1	3.5	3.2	2.8
Solvency Ratios				
Debt/EBITDA	0.0	0.3	0.2	0.2
Debt/EBITDA	0.0	0.3	0.2	0.2
Current Ratio	1.5	1.7	1.3	1.9
Quick Ratio	1.5	1.7	1.3	1.9

Source: Company, ICICI Direct Research

Exhibit 19: ICICI Direct coverage universe (IT)

Sector / Company	CMP			M Cap	EPS (₹)			P/E (x)			EV/EBITDA (x)			RoCE (%)			RoE (%)		
	(₹)	TP(₹)	Rating		FY18	FY19E	FY20E	FY18	FY19E	FY20E	FY18	FY19E	FY20E	FY18	FY19E	FY20E	FY18	FY19E	FY20E
Cyient (INFENT)	568	620	Hold	6,530	36.0	42.4	46.6	16.1	13.7	12.4	10.3	9.1	7.5	21.4	21.4	20.7	17.3	18.7	18.1
Eclerx (ECLSER)	1,133	910	Sell	3,931	72.9	58.9	64.2	14.2	17.5	16.1	9.1	11.1	9.9	28.2	22.8	23.1	24.1	17.3	17.5
Firstsource (FIRSOU)	51	60	Buy	3,502	4.8	5.4	5.9	10.7	9.4	8.6	8.8	7.2	6.2	13.0	14.0	15.7	13.9	13.9	13.8
HCL Tech (HCLTEC)	1,083	1,190	Hold	146,833	62.6	74.7	76.7	17.3	14.5	14.1	12.5	10.1	9.1	27.4	26.5	26.0	23.8	24.5	22.5
Infosys (INFTEC)	725	805	Buy	314,663	32.3	35.4	39.5	22.4	20.4	18.3	15.2	13.8	12.3	30.9	32.9	32.9	22.5	23.7	24.4
L&T Intotech (LTINFO)	1,715	1,940	Buy	29,148	64.7	87.3	94.6	26.0	19.2	17.7	23.2	14.3	12.3	36.0	40.4	36.4	28.8	31.0	27.8
NIIT Tech (NIITEC)	1,255	1,395	Hold	7,677	45.6	65.7	76.1	27.8	19.0	16.7	13.8	10.4	8.9	19.4	24.2	24.3	15.8	19.9	20.2
Persistent (PSYS)	622	650	Hold	5,119	40.5	44.0	48.7	15.8	14.6	13.2	9.1	7.1	6.4	19.8	20.5	20.5	15.2	15.0	14.9
TCS (TCS)	2,149	2,065	Hold	775,500	67.4	83.8	88.6	30.6	24.6	23.3	22.5	18.6	16.8	37.6	43.8	43.1	29.6	34.4	34.0
Tech M (TECMAH)	815	900	Buy	71,253	42.8	48.0	55.3	18.8	16.7	14.5	14.1	9.8	8.3	21.5	22.0	22.4	20.2	19.5	19.5
Wipro (WIPRO)	294	315	Buy	171,636	12.7	14.9	17.3	22.5	19.1	16.4	14.8	12.0	10.2	16.9	17.8	18.1	16.6	15.8	16.7

Source: Company, ICICI Direct Research

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Buy: >15%

Hold: -5% to 15%;

Reduce: -15% to -5%;

Sell: <-15%



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