

## Positive surprise on margin front...

HCL Tech reported a strong margin beat mainly on account of IBM products consolidation and SG&A optimisation. For FY20E, the company has raised its revenue guidance to 15-17% (from 14-16%) in constant currency. Of this, ~10-11% YoY growth would be organic while another ~5-6% growth would be attributed to inorganic. It has maintained its EBIT margin guidance of 18.5-19.5%. The board has recommended a bonus issue of 1:1.

## Likely to clock upper end of dollar revenue guidance

Revenues in constant currency grew 6% QoQ supported by full quarter consolidation of select IBM products acquisition. Though the revenue run rate of IBM deal is expected to be lower than earlier estimates (\$625 million annually) in FY20E, this along with other acquisitions is likely to lead to ~6% inorganic growth in the fiscal. The key highlight is ~10-11% growth estimate in organic business for FY20E. This is on the back of ramp up in existing deals and new deal signings (15 in Q2FY20). Additionally, easing of seasonality pressure in products & platforms business within IBM driven by renewals would ensure growth in Q3. Further, improving deal pipeline and incremental sources of revenue from infra clients is positive. Taking all this into consideration, HCL Tech has raised its revenue guidance to 15-17% in constant currency (13.2-15.2% in dollar terms). We believe the company would be able to clock the higher end of dollar revenue guidance in FY20E and estimate revenue CAGR of 12.3% in FY19-21E.

## Margin beats estimates, guidance retained

It was a sharp margin beat as EBIT margins expanded 290 bps QoQ to 20% (vs. our 18.1% estimate). Margins were driven by margin expansion in products & platforms business led by select IBM products acquisition, productivity benefits in ER&D business, SG&A optimisation along with positives from rupee benefit, lower visa & amortisation. This was partly countered by wage hike impact of 45 bps. One of the factors for margins being above our estimates was we accounted for higher amortisation for select IBM products acquisition. With marginal impact of partial wage hike likely in Q3FY20E, we expect EBIT margin of 19.1% in FY20E and FY21E.

## Valuation & Outlook

HCL Tech reported a healthy quarter from the perspective of margin expansion, deal signings and organic growth guidance. However, taking into consideration the company's quality of revenue growth, acquisition led strategy and lower dividend yield in near term (owing to recent IBM deal), we maintain our **HOLD** rating with a revised target price of ₹ 1200/share (~14x FY21E EPS).



### Particulars

Particular	Amount
Market Capitalization (₹ Crore)	151,849.6
Total Debt (FY19) (₹ Crore)	3,701.0
Cash & Equivalents (₹ Crore)	10,092.0
EV (₹ Crore)	145,458.6
52 week H/L	1190 / 920
Equity capital	271.0
Face value	₹ 2

### Key Highlights

- Company has raised its revenue guidance to 15-17% (from 14-16%) in constant currency for FY20E. Of this, ~10-11% YoY growth would be organic while another ~5-6% growth would be attributed to inorganic
- Company maintains EBIT margin guidance of 18.5-19.5% in FY20E
- Maintain HOLD rating with revised target price of ₹ 1200

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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	70,123	77,360	13.1%
EBITDA	10,309	11,440	13,968	16,058	18,180	14.1%
Margins (%)	22.1	22.6	23.1	22.9	23.5	
Net Profit	8,457	8,780	10,122	10,396	11,572	6.9%
EPS (₹)	60.0	62.6	74.7	76.6	85.3	
P/E	18.7	17.9	15.0	14.6	13.1	
RoNW (%)	25.3	24.1	24.5	21.3	20.6	
RoCE (%)	29.0	29.2	26.9	25.2	24.6	

Source: Company, ICICI Direct Research

**Exhibit 1: Variance Analysis**

	Q2FY20	Q2FY20E	Q2FY19	YoY (%)	Q1FY20	QoQ (%)	Comments
Revenue	17,528	17,567	14,860	18.0	16,425	6.7	Revenues in constant currency grew strongly by 6% QoQ supported by full quarter consolidation of select IBM products acquisition
Cost of sales (including employee expenses)	11,386	11,419	9,589	18.7	10,920	4.3	
Gross Margin	6,142	6,149	5,271	16.5	5,505	11.6	
Gross margin (%)	35.0	35.0	35.5	-43 bps	33.5	153 bps	
Selling & marketing costs	2,039	2,161	1,773	15.0	2,105	-3.1	
EBITDA	4,103	3,988	3,498	17.3	3,400	20.7	
EBITDA Margin (%)	23.4	22.7	23.5	-13 bps	20.7	271 bps	
Depreciation	606	817	533	13.7	595	1.8	
EBIT	3,497	3,171	2,965	17.9	2,805	24.7	
EBIT Margin (%)	20.0	18.1	20.0	0 bps	17.1	287 bps	Margins driven by margin expansion in products & platforms business led by select IBM products acquisition, productivity benefits in ER&D business, SG&A optimisation coupled with positives from rupee benefit, lower visa and amortisation. This was partly countered by wage hike impact of 45 bps
Other income	-3	149	252	-101.2	128	-102.3	
PBT	3,494	3,320	3,217	8.6	2,933	19.1	
Tax paid	835	797	678	23.2	705	18.4	
PAT	2,651	2,515	2,539	4.4	2,220	19.4	PAT was above our estimate led by beat at margin level while it was partly offset by lower other income

**Key Metrics**

Closing employees	147,123	147,900	127,875	15.1	143,900	2.2
Attrition - IT Services (%)	16.9	17.5	17.1	-20 bps	17.3	-40 bps
Average \$/₹	70.5	70.4	70.8	-0.4	69.5	1.5

Source: Company, ICICI Direct Research

**Exhibit 2: Change in estimates**

	FY19			FY20E			FY21E			Comments
(₹ Crore)	Old	New	% Change	Old	New	% Change	Old	New	% Change	
Revenue	60,427	69,575	70,123	0.8	77,296	77,360	0.1			
EBIT	11,820	12,906	13,410	3.9	14,493	14,786	2.0			
EBIT Margin (%)	19.6	18.6	19.1	52 bps	18.8	19.1	36 bps			We tweak our margin estimates mainly on account of strong margin performance in Q2FY20
PAT	10,122	9,993	10,396	4.0	11,132	11,572	4.0			
EPS (₹)	74.7	73.7	76.6	4.0	82.1	85.3	4.0			Uptick in EPS estimates due to revision in margin estimates

Source: Company, ICICI Direct Research

## Conference Call Highlights

- **Revenue outlook** - The company has raised its revenue guidance to 15-17% (from 14-16%) in constant currency for FY20E. Of this, ~10-11% YoY growth would be organic while another ~5-6% growth would be attributed to inorganic. Healthy degree of organic growth estimates is on the back of existing deal ramp ups and good deal wins. HCL has completed the acquisition of select IBM products on June 30, 2019 and has consolidated in Q2FY20
- **Margin walk through**- EBIT margins expanded 290 bps QoQ to 20% on account of 1) margin expansion in products & platforms business led by select IBM products acquisition, margin up-tick in ER&D and business (+210 bps) 2) SG&A optimisation (+70 bps) and 3) currency, lower visa costs and amortisation (~50 bps) partly offset by wage hike (-45 bps). HCL Technologies has maintained its EBIT margin guidance to 18.5-19.5% in FY20E
- **Vertical commentary** – The company has restructured its revenue segregation among geographies and verticals. Further, revenue contribution by select IBM products acquisition would be seen across revenue segments. Additionally, ramp up in existing clients led to 18% QoQ growth in financial services in the quarter. The management indicated that momentum was witnessed in digital transformation in retail banks while capital market segment continued to see pressure. On retail & CPG, the management said Q3FY20 would be soft for the segment due to completion of certain projects. However, the commentary remains positive from medium term perspective
- **Good deal signings**- The company signed 15 transformational deals during the quarter driven by financial services, lifesciences & healthcare, manufacturing and retail & CPG verticals
- **Mode 2, 3 witness healthy growth** - The IBM products acquisition will be reflected in Mode 3 business. Mode 2 (digital business) and mode 3 (product business), which are into newer age technologies together constituted 33% of revenues. Mode 2 revenues increased 3% QoQ and Mode 3 revenues witnessed growth of 42% QoQ led by select IBM products acquisition. In terms of margins, Mode 2 margins improved 80 bps QoQ to 14% while Mode 3 margins improved to 27.1% (vs. 19% in Q1)
- **Tax rate**- Effective tax rate for the quarter came in at 23.9%. The management said it would continue with the current tax structure and would not follow the new tax rate cut structure announced by the government for the next few years
- **Amortisation schedule**- Owing to IBM products acquisition, amortisation in Q2FY20 was at \$38 million and would be \$107 million in H2FY20. Total amortisation would be at \$145 million for FY20E and \$271 million for FY21E. Amortisation on acquired products will need to be adjusted against revenues till contracts are with IBM with amortisation to show below the line as contracts get migrated to HCL
- **R&D expenses** - Providing the segregation of R&D expenses within P&L for the first time, R&D expenses were at 1.9% of total revenue

## Key Metrics

### Exhibit 3: Geography wise break-up

	% contribution to revenues Q2FY20	CC Growth QoQ (%)	CC Growth YoY (%)
<b>Revenue by geography (%)</b>			
Americas	64.4	0.1	16.3
Europe	28.2	17.1	30.9
RoW	7.4	24.4	20.8

Source: Company, ICICI Direct Research

Revenue growth in the quarter was led by Europe and RoW

### Exhibit 4: Industry wise break-up

	% contribution to revenues Q2FY20	CC Growth QoQ (%)	CC Growth YoY (%)
<b>Revenue by verticals (%)</b>			
Financial Services	22.4	18.0	19.0
Manufacturing	19.8	5.4	33.0
Lifesciences & Healthcare	12.9	6.6	19.9
Public Services	11.0	10.7	23.7
Retail & CPG	10.0	12.2	21.3
Technology & Services	15.4	-14.3	0.5
Telecommunications, Media, Publishing & Entertainment	8.4	10.8	40.1

Source: Company, ICICI Direct Research

Financial services growth was due to IBM deal along with ramp up in existing clients

### Exhibit 5: Segment offering wise break-up

	% contribution to revenues Q2FY20	% contribution to revenues Q1FY20	CC Growth QoQ (%)	CC Growth YoY (%)
<b>Revenue by verticals (%)</b>				
IT and Business Services	71.4	75.3	0.9	17.4
Engineering and R&D Services	16.9	16.9	5.4	15.0
Products & Platforms	11.7	7.8	56.8	57.9

Source: Company, ICICI Direct Research

Revenue from select IBM products gets consolidated in P&P business and visible in the 56.8% QoQ growth rate in this quarter

**Exhibit 6: Client & human resource matrix**

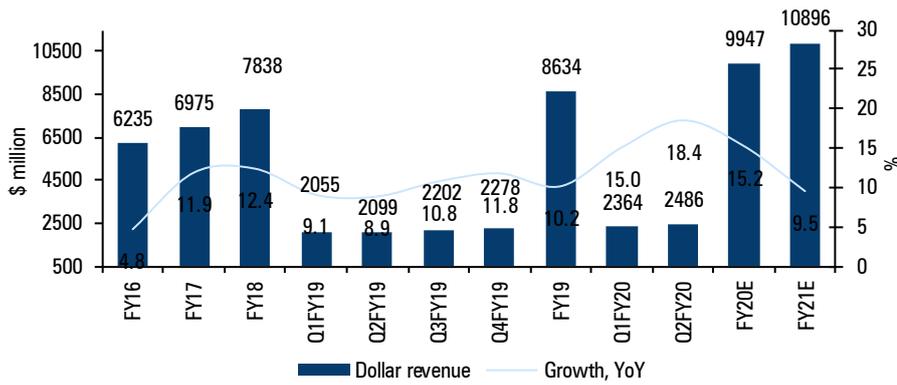
	Q1FY19	Q2FY19	Q3FY19	Q4FY19	Q1FY20	Q2FY20
<b><u>Client metrics</u></b>						
US\$1-5 million	304	306	321	340	340	368
US\$10-20 million	75	75	69	71	79	78
US\$50-100 million	23	22	19	19	17	17
US\$100 million+	9	9	10	10	12	13
<b><u>Headcount, Utilization &amp; Attrition</u></b>						
Total Employees	124,121	127,875	132,328	137,965	143,900	147,123
Attrition - IT Services (LTM)	16.3	17.1	17.8	17.7	17.3	16.9

Source: Company, ICICI Direct Research

*Attrition decline witnessed in this quarter*

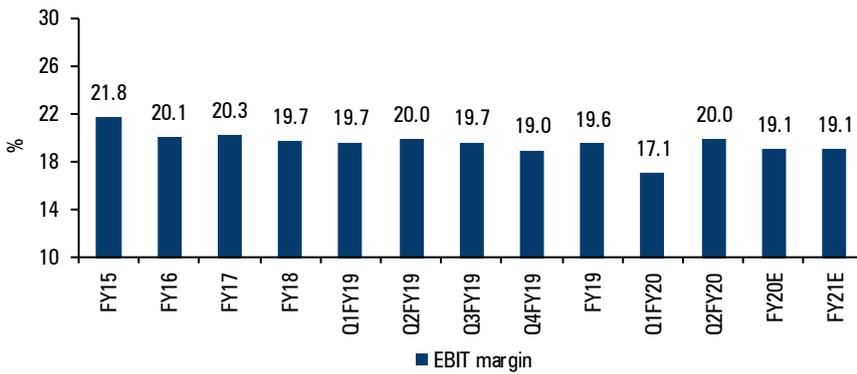
### Financial story in charts

Exhibit 7: Dollar revenues may grow at 12.3% CAGR in FY19-21E



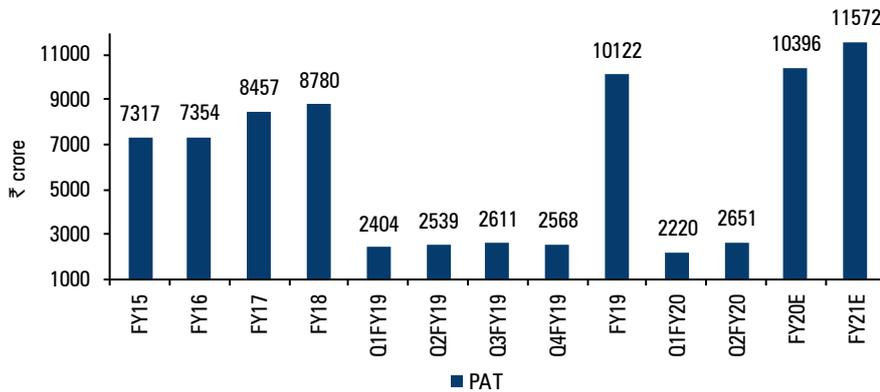
Source: Company, ICICI Direct Research

Exhibit 8: Revise our margin estimates upwards



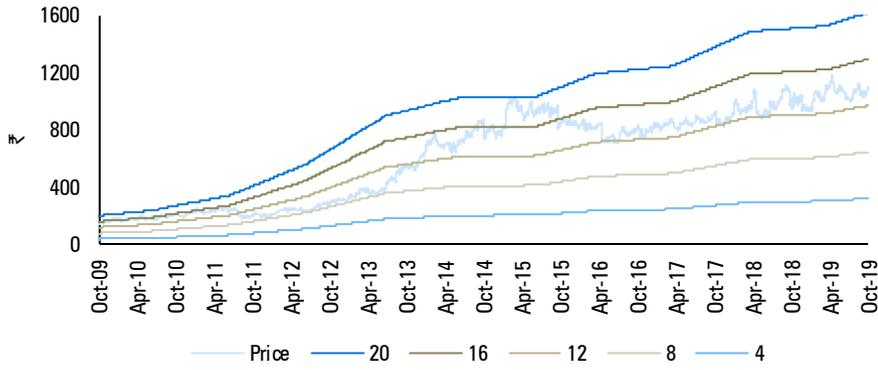
Source: Company, ICICI Direct Research

Exhibit 9: PAT trend



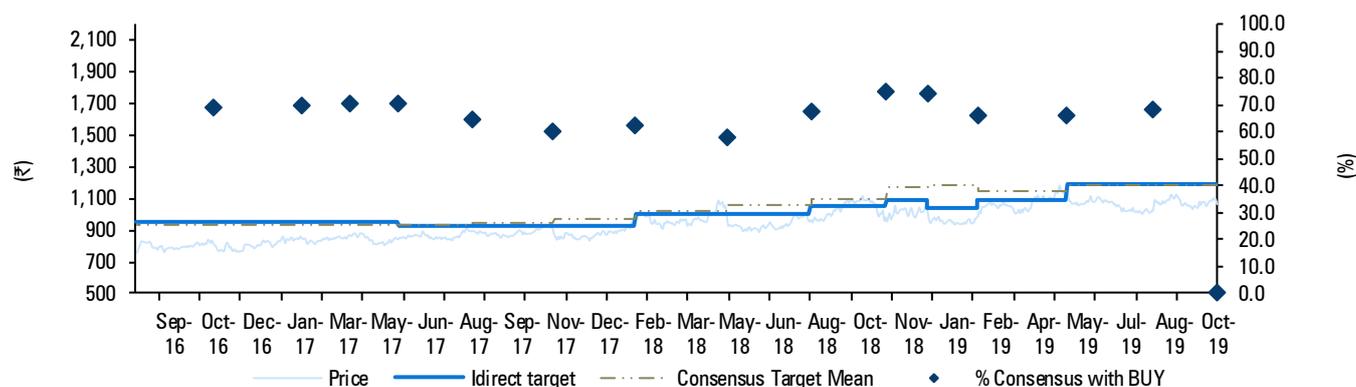
Source: Company, ICICI Direct Research

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.	30-Jun-19	42.9%	581.9	0.0
2	HCL Holdings Pvt. Ltd.	30-Jun-19	16.5%	223.3	0.0
3	Artisan Partners Limited Partnership [Activist]	30-Sep-19	1.5%	20.2	0.0
4	ICICI Prudential Asset Management Co. Ltd.	30-Sep-19	1.5%	19.7	1.8
5	The Vanguard Group, Inc.	30-Sep-19	1.4%	19.4	0.0
6	SBI Funds Management Pvt. Ltd.	30-Sep-19	1.4%	18.9	0.1
7	BlackRock Institutional Trust Company, N.A.	30-Sep-19	1.3%	17.5	0.0
8	Vontobel Asset Management, Inc.	31-Aug-19	1.2%	16.7	0.0
9	Aditya Birla Sun Life AMC Limited	30-Sep-19	0.8%	11.4	0.1
10	Lazard Asset Management, L.L.C.	30-Sep-19	0.8%	10.3	0.0

Source: Reuters, ICICI Direct Research

Exhibit 13: Recent Activity

Buys			Sells		
Investor name	Value	Shares	Investor name	Value	Shares
ICICI Prudential Asset Management Co. Ltd.	28.21m	1.84m	RBC Global Asset Management (Asia) Limited	-20.94m	-1.36m
Reliance Nippon Life Asset Management Limited	21.32m	1.39m	APG Asset Management N.V.	-16.19m	-1.03m
Tata Asset Management Limited	9.40m	0.61m	Florida State Board of Administration	-12.71m	-0.81m
Nomura Asset Management Singapore Ltd.	8.52m	0.55m	Tredje AP Fonden	-10.16m	-0.66m
AGF International Advisors Company Ltd.	7.99m	0.52m	Nuveen LLC	-9.75m	-0.64m

Source: Reuters, ICICI Direct Research

Exhibit 14: Shareholding Pattern

(in %)	Mar-19	Jun-19	Sep-19
Promoter	60.00	60.00	60.00
Public	40.00	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	
<b>Total operating Income</b>	<b>50,570</b>	<b>60,427</b>	<b>70,123</b>	<b>77,360</b>	
Growth (%)	8.2	19.5	16.0	10.3	
Direct costs	33,237	39,268	45,510	50,207	
S,G&A expenses	5,894	7,191	8,555	8,974	
Total Operating Expenditure	39,131	46,459	54,065	59,181	
<b>EBITDA</b>	<b>11,440</b>	<b>13,968</b>	<b>16,058</b>	<b>18,180</b>	
Growth (%)	11.0	22.1	15.0	13.2	
Depreciation	1,453	2,148	2,649	3,394	
Amortisation	-	-	-	-	
Net Other Income	1,111	805	269	441	
PBT	11,098	12,625	13,679	15,226	
Forex adjustments	-	-	-	-	
Total Tax	2,316	2,481	3,283	3,654	
<b>PAT</b>	<b>8,780</b>	<b>10,122</b>	<b>10,396</b>	<b>11,572</b>	
Growth (%)	3.8	15.3	2.7	11.3	
EPS (₹)	62.6	74.7	76.6	85.3	
Growth (%)	4.3	19.3	2.7	11.3	

Source: Company, ICICI Direct Research

Exhibit 17: Balance sheet		₹ crore			
	FY18	FY19	FY20E	FY21E	
<b>Liabilities</b>					
Equity Capital	278	271	271	271	
Reserve and Surplus	36,108	41,095	48,450	55,960	
Total Shareholders funds	36,386	41,366	48,721	56,231	
Total Debt	380	3,701	3,701	3,701	
Other liabilities + Provisions	1,192	1,830	1,710	1,783	
Minority Interest / Others	-	103	103	103	
<b>Total Liabilities</b>	<b>37,958</b>	<b>47,000</b>	<b>54,235</b>	<b>61,818</b>	
<b>Assets</b>					
Net Block + CWIP	4,880	5,528	8,886	8,973	
Intangible assets + Goodwill	14,193	17,595	24,140	24,140	
Investments	303	85	85	85	
Liquid investments	2,357	2,220	2,220	2,220	
Inventory	172	91	106	117	
Debtors	9,639	11,706	13,584	14,986	
Loans and Advances	3,645	1,667	2,516	2,002	
Other Current Assets	4,962	6,521	9,116	8,510	
Cash	4,018	7,872	4,414	9,544	
Total Current Assets	24,793	30,077	31,956	37,378	
Total Current Liabilities	10,065	11,575	16,122	14,048	
Net Current Assets	14,728	18,502	15,834	23,329	
Other non current assets	3,854	5,290	5,290	5,290	
<b>Application of Funds</b>	<b>37,958</b>	<b>47,000</b>	<b>54,235</b>	<b>61,818</b>	

Source: Company, ICICI Direct Research

Exhibit 16: Cash flow statement		₹ crore			
	FY18	FY19	FY20E	FY21E	
PBT	11,098	12,625	13,679	15,226	
Depreciation & Amortisation	1,453	2,148	2,649	3,394	
(Inc)/dec in Current Assets	(4,651)	(1,540)	(5,337)	(292)	
Inc/(dec) in CL and Provisions	(228)	1,052	4,427	(2,001)	
Taxes paid	(2,356)	(2,621)	(3,283)	(3,654)	
<b>CF from operating activities</b>	<b>4,724</b>	<b>10,975</b>	<b>11,866</b>	<b>12,232</b>	
(Inc)/dec in Investments	3,291	3,193	269	441	
(Inc)/dec in Fixed Assets	(5,321)	(3,434)	(6,007)	(3,481)	
<b>CF from investing activities</b>	<b>(2,283)</b>	<b>(3,073)</b>	<b>(12,283)</b>	<b>(3,041)</b>	
Issue/(Buy back) of Equity	-	-	-	-	
Inc/(dec) in loan funds	(148)	3,623	-	-	
Dividend paid & dividend tax	(2,031)	(1,321)	(3,041)	(4,062)	
Inc/(dec) in debentures	-	-	-	-	
Others	(5)	(18)	-	-	
<b>CF from financing activities</b>	<b>(5,714)</b>	<b>(1,462)</b>	<b>(3,041)</b>	<b>(4,062)</b>	
Net Cash flow	(3,226)	6,239	(3,458)	5,129	
Exchange difference	47	(201)	-	-	
Opening Cash	1,317	4,018	7,872	4,414	
Bank bal + unclaimed dvd.	-	-	-	-	
<b>Cash c/f to balance sheet</b>	<b>4,018</b>	<b>7,872</b>	<b>4,414</b>	<b>9,544</b>	

Source: Company, ICICI Direct Research

Exhibit 18: Key ratios		₹ crore			
	FY18	FY19	FY20E	FY21E	
<b>Per share data (₹)</b>					
EPS	62.6	74.7	76.6	85.3	
Cash EPS	73.0	90.5	96.2	110.3	
BV	259.4	305.1	359.2	414.6	
DPS	12.0	8.0	22.4	29.9	
Cash Per Share	28.6	58.1	32.5	70.4	
<b>Operating Ratios (%)</b>					
EBIT Margin	19.7	19.6	19.1	19.1	
PBT Margin	21.9	20.9	19.5	19.7	
PAT Margin	17.4	16.8	14.8	15.0	
Debtor days	70	71	71	71	
<b>Return Ratios (%)</b>					
RoE	24.1	24.5	21.3	20.6	
RoCE	29.2	26.9	25.2	24.6	
RoIC	33.1	33.8	29.5	31.1	
<b>Valuation Ratios (x)</b>					
P/E	17.9	15.0	14.6	13.1	
EV / EBITDA	12.7	10.4	9.3	7.9	
EV / Net Sales	2.9	2.4	2.1	1.9	
Market Cap / Sales	3.0	2.5	2.2	2.0	
Price to Book Value	4.3	3.7	3.1	2.7	
<b>Solvency Ratios</b>					
Debt/EBITDA	0.0	0.3	0.2	0.2	
Debt/EBITDA	0.0	0.3	0.2	0.2	
Current Ratio	1.6	1.5	1.4	1.6	
Quick Ratio	1.6	1.5	1.4	1.5	

Source: Company, ICICI Direct Research

**Exhibit 19: ICICI Direct coverage universe (IT)**

Sector / Company	CMP			M Cap (₹ Cr)	EPS (₹)			P/E (x)			EV/EBITDA (x)			RoCE (%)			RoE (%)		
	(₹)	TP(₹)	Rating		FY19	FY20E	FY21E	FY19	FY20E	FY21E	FY19	FY20E	FY21E	FY19	FY20E	FY21E	FY19	FY20E	FY21E
HCL Tech (HCLTEC)	1,120	1,200	Hold	151,850	74.7	76.6	85.3	15.0	14.6	13.1	10.4	9.3	7.9	26.9	25.2	24.6	24.5	21.3	20.6
Infosys (INFTEC)	642	855	Hold	343,388	35.4	39.1	44.8	22.3	20.2	17.6	15.2	13.6	11.7	32.9	32.4	34.3	23.7	24.2	25.6
MindTree (MINCON)	716	690	Hold	11,953	45.9	33.7	45.8	15.9	21.6	15.9	10.3	10.9	8.5	29.8	22.1	26.5	22.8	15.3	18.6
L&T Intotech (LTINFO)	1,662	1,870	Buy	27,985	87.3	86.2	101.0	18.5	18.7	16.0	13.7	12.8	10.6	40.4	33.5	33.1	31.0	25.7	25.4
NIIT Tech (NIITEC)	1,480	1,345	Hold	8,125	65.7	74.3	83.9	20.1	18.3	16.0	11.1	9.3	7.9	24.2	23.5	23.8	19.9	19.8	19.7
TCS (TCS)	2,069	2,005	Hold	739,500	83.8	86.2	95.5	23.4	22.8	20.6	17.7	16.6	14.8	43.8	42.6	43.9	34.4	33.4	34.4
Tech M (TECMAH)	727	850	Buy	65,381	47.7	45.8	51.7	15.2	15.8	14.1	9.1	9.1	7.9	23.6	21.1	21.2	21.2	17.9	17.8
Wipro (WIPRO)	249	300	Buy	150,558	14.9	17.2	20.5	16.7	14.5	12.2	10.2	9.9	7.9	17.8	18.7	20.0	15.8	18.0	19.1

Source: Company, ICICI Direct Research

## RATING RATIONALE

ICICI Direct endeavors to provide objective opinions and recommendations. ICICI Direct assigns ratings to its stocks according to their notional target price vs. current market price and then categorizes them as Buy, Hold, Reduce and Sell. The performance horizon is two years unless specified and the notional target price is defined as the analysts' valuation for a stock

Buy: >15%

Hold: -5% to 15%;

Reduce: -15% to -5%;

Sell: <-15%



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