Sharekhan
by BNP PARIBAS

HCL Technologies

Strong quarter, raised guidance

Sector: IT & ITES
Results update

	Change
Reco: **Buy**	↔
CMP: **Rs. 1,096**	
Price Target: **Rs. 1,275**	↑

↑ Upgrade ↔ No change ↓ Downgrade

Company details

Market cap:	Rs. 148,614 cr
52-week high/low:	Rs. 1,190 / 920
NSE volume: (No of shares)	18.6 lakh
BSE code:	532281
NSE code:	HCLTECH
Sharekhan code:	HCLTECH
Free float: (No of shares)	54.3 cr

Shareholding (%)

Promoters	60.0
FII	28.0
DII	8.6
Others	3.4

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	1.5	4.7	-3.0	9.4
Relative to Sensex	-1.0	1.9	-4.6	-5.3

Sharekhan Research, Bloomberg

HCL Technologies (HCL Tech) reported strong revenue growth, higher-than-expected margin performance and increased revenue growth guidance. Strong revenue growth was driven by healthy performance in financial vertical and additional $100+ million revenue contribution from IBM select products acquisitions (lower-than our estimates). Organic CC revenue growth is at around 1.5%/14% q-o-q/y-o-y, ahead of our estimates. EBIT margin improved 287BPS q-o-q to 20.0%, ahead of our expectations, aided by the improvement in core business as well as integration of high-margin IB products. The margin of ERS business improved significantly on q-o-q basis. Management increased its revenue growth guidance to 15-17% for FY2020E and expects acceleration in organic revenue contribution (10-11% from 8-9% earlier). Organic growth guidance has been increased on the back of good bookings in Q2FY2020 and strong organic growth in 1HFY2020. EBIT margin would be impacted in Q3FY2020 owing to higher amortization expenses (2H amortisation is $107 million, higher than 1H). The company announced 1:1 bonus during the quarter.

Key positives

- Strong CC revenue growth of 6/20.5% q-o-q/y-o-y, including inorganic revenue components from IBM select products
- Margins beat, aided by strong operating performance in both core business as well as IBM product integration
- Revenue guidance for FY2020E raised to 15-17% and indicated acceleration in organic growth to 10-11% vs. 8-10% earlier

Key negatives

- Mode-2 growth decelerated on a q-o-q basis
- Continued weakness in capital market segment of financial services vertical

Our Call

Valuation – Maintain Buy with revised PT of Rs. 1,275: We have fine-tuned our earnings estimates for FY2020E/FY2021E, factoring in an increase in revenue growth guidance, while we have already considered higher amortisation expenses in our model. Good deal wins during the quarter along with large addressable opportunity in IMS provides the visibility of industry-leading organic revenue among large peers in FY2020E. At CMP, the stock trades at 15x/13x its FY2020/FY2021 earnings estimates, which look attractive considering better revenue growth versus peers over FY2019-FY2021E. We maintain our Buy rating on the stock with a revised PT of Rs. 1,275.

Key Risks

Any integration issues in ongoing M&A activities especially IP-related transactions could impact earnings. Further, high dependence on IMS could create challenges to its revenue growth trajectory.

Valuation Rs cr

Particulars	FY17	FY18	FY19	FY20E	FY21E
Revenue	46,722.0	50,570.0	60,427.0	70,006.5	76,970.8
OPM (%)	22.1	22.6	23.1	22.9	23.4
Adjusted PAT	8,456.0	8,780.0	10,123.0	10,133.0	11,292.3
% YoY growth	*15.0*	*3.8*	*15.3*	*0.1*	*11.4*
Adjusted EPS (Rs.)	60.7	62.6	73.6	74.7	83.2
P/E (x)	18.0	17.5	14.9	14.7	13.2
P/B (x)	4.7	4.3	3.8	3.2	2.9
EV/EBITDA (x)	15.1	13.0	10.6	9.3	8.2
RoNW (%)	27.9	25.3	26.0	23.1	23.0
RoCE (%)	31.5	30.0	29.2	26.0	25.9

Source: Company; Sharekhan Research

Strong quarter

HCL Tech delivered better-than-expected performance across all financial parameters. HCL Tech impressed with strong constant currency (CC) revenue growth of 6% q-o-q and 20.5% y-o-y, led by strong growth in financial services (7.4% q-o-q and 8.5% y-o-y CC), while additional revenue contribution from IBM select products remained below our expectations. Organic CC revenue growth is at around 1.5% (ahead of our estimates) and rest from IBM select product acquisition. On a reported basis, USD revenue grew by 5.2%/18.4% q-o-q/y-o-y to $2,485.6 million in Q2FY2020. EBIT margin improved 287BPS q-o-q to 20.0%, ahead of our expectations, aided by (1) contribution of revenues from high-margin IBM product, (2) absence of upfront investments for IBM products (+70 BPS), (3) rupee tailwind and absence of visa costs (+ 32 BPS) and (4) lower amortisation expenses (+15 BPS). These margin tailwinds were partially offset by wage revisions for large portion of its employees (- 45 BPS). Further, EBIT margin of ER&D services improved sharply to 21.4% from 16.3% in the previous quarter. Net profit came at Rs. 2,651 crore and ahead of our estimates, aided by improved operating performance.

Raised revenue growth guidance, board approved bonus shares

HCL Tech's management has raised FY2020E CC revenue growth guidance to 15-17% from 14-16% earlier, led by good deal booking during the quarter. Organic growth guidance has been increased to 10-11% from 8-10% and 7-9% at the beginning of the year, on the back of strong organic growth in 1HFY2020. Further, mode-2 (proxy of digital business) and mode-3 (products and platforms) together contributes to 33% of the total revenue, which is expected to support the revenue growth going ahead considering the strong traction among its customers. Further, the acquisition of product business helped the company to get exposure to a large number of customers, which has opened up the cross selling opportunities of its own products as well as services. Though there would be pressure in IMS business owing to higher renewal in coming quarters, the management believes that modernisation of data centre and large addressable market (HCL Tech has ~3-4% market share) would provide incremental source of revenues. Though management continues to see weakness in financial services, demand for digital works in the retail banking space would continue to drive the growth. Further, management indicated that it sees at least next 3-4 quarters of sequential growth in its product business. The company announced 1:1 bonus during the quarter.

Key result highlights from earnings call

- **HCL Tech raised revenue guidance:** HCL Tech increased CC revenue growth guidance of 15%-17% for FY2020E. The guidance bakes in 5-7% contribution to growth from acquisitions from 6% earlier. Organic growth guidance has been increased to 10-11% from 8-10% on the back of strong organic growth in 1HFY20 and good deal bookings during the quarter.
- **Large deals to drive strong organic growth:** Strong organic growth in the past few quarters was due to ramp-up of mega deals. HCL Tech signed 15 transformational deals in the quarter led by financial services, life science and healthcare, manufacturing and retail & CPG verticals.
- **Client metrics:** $100 million and $50 million client buckets increased by 1 to 13 and 30 sequentially. On y-o-y basis, number of $100 million clients was up by 4, while number of $50 million clients declined by 1.
- **Financial services:** HCL Tech reported strong growth in financial services on the back of number of ramp-ups in some of the existing clients and the project work. The management has indicated that it sees a lot of traction for its digital offerings in the retail banking space. The pick-up in digital transformation in retail backing space is expected to drive its growth going ahead. However, the company continues to see weakness in the capital market segment owing to pricing pressure and lower interest rates. Mode-2 growth in financial vertical is expected to offset the softness in certain clients spending.
- **Retail & CPG vertical:** The 1H2020 was good in terms of booking and revenue perspective. Though the growth in retail vertical could remain soft in Q3FY2020E, management remains positive in medium-term perspective.
- **Commentary on IMS:** Management acknowledged that the renewal pressure is quite high in later part of FY2020E and early FY2021E. As a lot of customers are looking at modernizing data centers, it can give HCL Tech an opportunity to modernise the application landscape. Large addressable market would help to drive its growth in IMS business.

Results

Rs cr

Particulars	Q2FY20	Q2FY19	Q1FY20	y-o-y (%)	q-o-q (%)
Revenue ($ mn)	**2,485.6**	**2,098.6**	**2,363.6**	**18.4**	**5.2**
Net sales	**17,528.0**	**14,861.0**	**16,425.0**	**17.9**	**6.7**
Direct costs	11,061.0	9,363.0	10,631.0	18.1	4.0
Gross profit	**6,467.0**	**5,498.0**	**5,794.0**	**17.6**	**11.6**
SG&A	2,039.0	1,773.0	2,105.0	15.0	-3.1
EBITDA	**4,428.0**	**3,725.0**	**3,689.0**	**18.9**	**20.0**
Depreciation and amortisation	606.0	533.0	595.0	13.7	1.8
EBIT	**3,822.0**	**3,192.0**	**3,094.0**	**19.7**	**23.5**
Forex gain/(loss)	-10.0	69.0	19.0	-114.5	-152.6
Other income	7.0	183.0	109.0	-96.2	-93.6
PBT	**3,819.0**	**3,444.0**	**3,222.0**	**10.9**	**18.5**
Tax provision	835.0	678.0	705.0	23.2	18.4
Net profit	**2,651.0**	**2,541.0**	**2,220.0**	**4.3**	**19.4**
EPS (Rs.)	19.5	18.7	16.4	4.3	19.4
Margin (%)				**BPS**	**BPS**
EBITDA	25.3	25.1	22.5	20	280
EBIT	21.8	21.5	18.8	33	297
NPM	15.1	17.1	13.5	-197	161

Source: Company; Sharekhan Research

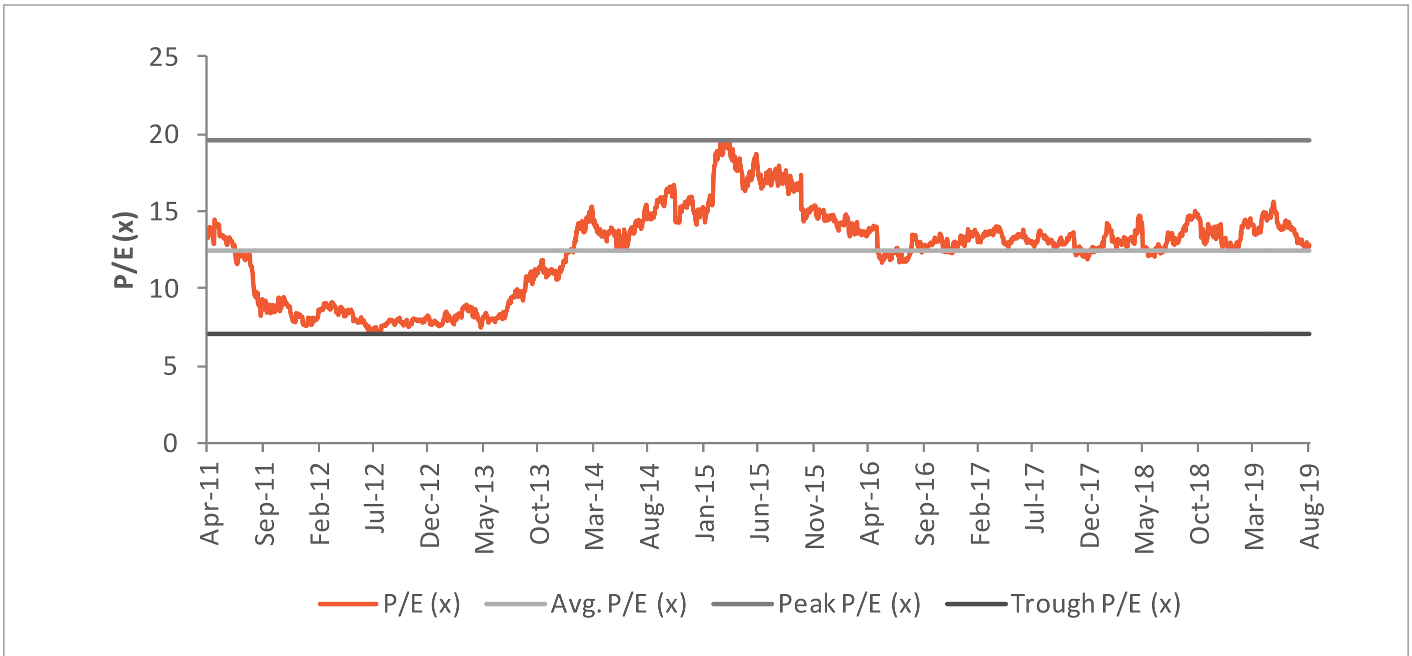
Outlook

Growth for Indian IT is expected to accelerate from current 6-7% as demand for digital services grows rapidly. India will continue to remain the preferred destination for talent supply and create a gradual shift of digital business from onsite. HCL Tech has invested aggressively in the fast-growing Mode-2 (a good proxy for digital offering) capabilities, which would help the company to match with the industry's growth. Further, the company has made large investments towards the acquisition of IP products to diversify its focus on new high-margin revenue streams. The addressable market opportunity for IMS is very large with only 10-12% penetration of addressable market. Given its differentiated positioning in IMS and strong capabilities in engineering services, HCL Tech is well positioned to maintain growth momentum in these segments going ahead.

Valuation

We maintain our Buy rating on the stock with a revised PT of Rs. 1,275. At CMP, the stock trades at 15x/13x its FY2020/FY2021 earnings estimates, which look attractive considering better revenue growth versus peers over FY2019-FY2021E. We have fine-tuned our earnings estimates for FY2020E/FY2021E, factoring in increase in revenue growth guidance, while we have already considered higher amortisation expenses in our model. Good deal wins during the quarter along with large addressable opportunity in IMS provides visibility of industry-leading organic revenue among large peers in FY2020E.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer valuation

Particulars	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)		EV/EBIDTA (x)		P/BV (x)		RoE (%)	
				FY20E	FY21E	FY20E	FY21E	FY20E	FY21E	FY20E	FY21E
HCL Tech	1,096	136	1,48,614	14.7	13.2	9.3	8.2	3.2	2.9	23.1	23.0
Infosys	651	426	2,77,116	16.9	15.1	11.3	10.1	2.3	2.3	25.5	28.5
TCS	2,075	375	7,78,714	23.8	21.6	17.6	15.8	7.9	7.2	34.7	34.7
Tech M	727	96	70,108	15.2	13.0	9.7	7.9	3.1	2.7	19.3	19.8
Wipro	254	571	1,45,308	15.1	13.8	9.3	8.1	3.1	2.8	17.8	17.4

Source: Company, Sharekhan estimates

About company

HCL Tech is a leading global technology company providing software-led IT solutions, remote infrastructure management, and BPO services and engineering-related services. Further, the company helps global enterprises re-imagine and transform their businesses through digital technology transformation. HCL Tech leverages its global network of integrated co-innovation labs and global delivery capabilities to provide holistic multi-service delivery in key industry verticals.

Investment theme

HCL Tech's revenue growth momentum is expected to accelerate, led by several large deal wins in the past few quarters and gradual recovery in infrastructure management services. The company focuses on chasing large deals to capture market share from incumbents in consolidation deals. Being the leader in IMS practices and the third-largest engineering services player globally in revenue, the company is well positioned to win large deal wins. Strong deal wins along with acquisition of select IP products will help the company to drive growth going ahead.

Key Risks

1) Continued slowdown in organic revenue growth, 2) integration issues in ongoing M&A activities, especially IP-related transactions, 3) rupee appreciation and/or adverse cross-currency movements, 4) pressure in renewal of IMS deals, 5) any hostile regulatory visa norms could have an impact on employee expenses, and 6) any major macro issues in developed markets, especially in the U.S. and Europe.

Additional Data

Key management personnel

Shiv Nadar	Founder & Chairman
C Vijay Kumar	President & CEO
Prateek Aggarwal	Chief Financial Officer
G H Rao	President - Engineering and R&D Services
Rahul Singh	President – Financial Services

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Vama Sundari Investments Delhi Pvt	42.90
2	HCL Holdings Pvt Ltd	16.46
3	BlackRock Inc	1.61
4	Artisan Partners LP	1.48
5	Vanguard Group Inc/The	1.45
6	ICICI Prudential Asset Management	1.35
7	SBI Funds Management Pvt Ltd	1.30
8	Life Insurance Corp of India	1.11
9	Nomura Holdings Inc	0.98
10	Vontobel Holding AG	0.88

Source: Bloomberg

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