

Sector: IT & ITES

Result Update

	Change
Reco: Buy	↔
CMP: Rs. 623	
Price Target: Rs. 750	↑
↑ Upgrade ↔ No change ↓ Downgrade	

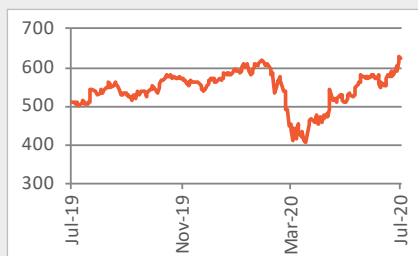
Company details

Market cap:	Rs. 169,184 cr
52-week high/low:	Rs. 652/375
NSE volume: (No of shares)	20.4 lakh
BSE code:	532281
NSE code:	HCLTECH
Sharekhan code:	HCLTECH
Free float: (No of shares)	54.3 cr

Shareholding (%)

Promoters	60.3
FII	25.6
DII	10.1
Others	4.0

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	8.3	36.9	5.1	22.4
Relative to Sensex	-1.8	20.0	17.0	27.5

Sharekhan Research, Bloomberg

HCL Tech reported largely in-line revenue performance, while EBIT margin and net profit beat our estimates. Constant currency (CC) revenue declined 7.2% q-o-q, broadly in-line with our estimates, owing to supply-side constraints due to COVID-19 (1/3rd of total revenue impact from COVID) and reduction of revenue from offshoring of a large deal. IT and business services (down 7.8% q-o-q CC) and engineering R&D (down 9% q-o-q CC) were the key drags on revenues owing to exposure to troubled verticals and asset heavy industries. EBIT margin contracted 36bps q-o-q to 20.5%, beating our estimates, owing to increased amortisation due to its investments (-67bps), higher R&D expenditure (-12bps), revenue decline (-70bps), partially offset by benefits from rupee depreciation (+76bps) and reduction in travel expenses (+40bps). Net profit of Rs. 2,923 crore (down 7.3% q-o-q) was 8.6% ahead of our estimates aided by higher profitability and higher other income (includes sale of land parcel of \$14.4 million). The management also highlighted that COVID-19 related impact on the demand side stabilized after initial impact of ramp-downs, volume reduction and discounts to some customers in the stressed sectors. Hence, the management provided its guidance on revenue growth in the range of 1.5% - 2.5% q-o-q for the remaining quarters of FY2021. This guidance translates to -3.3% to -0.8% growth in FY2021. On margin front, management expects EBIT margin to be in the range of 19.5-20.5% for FY2021 (EBIT margin was at 19.6% in FY2020). HCL Tech impressed with flow of large deal wins, strong FCF generation and strong margin defense.

Key positives

- ♦ Strong order bookings and healthy deal pipeline (up 40% y-o-y); secured vendor consolidation deal
- ♦ HCL software revenue has been progressing well as per earlier guidance
- ♦ Free Cash Flow (FCF) at \$757 mn with FCF to net income conversion at 196%.

Key negatives

- ♦ ERD revenue declined 9% q-o-q CC
- ♦ Mode-3 margin contracted 70bps q-o-q

Our Call

Valuation – Maintain Buy with revised PT of Rs. 750: We have revised our earnings estimates upward for FY2021E/FY2022E, to factor in better-than-expected margin performance in Q1FY2021 and commentary on stabilization of demand-side impact owing to COVID-19. Strong order flows and vendor consolidation would help the company return to a sequential positive growth trajectory. Robust demand for managed services on cloud platforms and emergence of new business models for deeply impacted verticals would create opportunities for the company. At CMP, the stock trades at 15x/14x of its FY2021E/FY2022E earnings. The company has impressed with consistent wins of large deals, strong FCF generation and good margin defense. We maintain our Buy rating on the stock with a revised PT of Rs. 750.

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.

	Rs cr				
Particulars	FY18	FY19	FY20	FY21E	FY22E
Revenue	50,570.0	60,427.0	70,678.0	73,005.0	78,869.3
OPM (%)	22.6	23.1	23.6	24.8	24.4
Adjusted PAT	8,780.0	10,123.0	11,061.0	11,308.9	12,217.4
% YoY growth	3.8	15.3	9.3	2.2	8.0
Adjusted EPS (Rs.)	31.3	36.8	40.8	41.7	45.0
P/E (x)	19.9	16.9	15.3	15.0	13.8
P/B (x)	2.4	2.1	3.3	3.0	2.7
EV/EBITDA (x)	7.3	5.9	5.0	4.6	4.3
RoNW (%)	25.3	26.0	23.8	20.9	20.4
RoCE (%)	30.0	29.2	25.3	22.8	22.4

Source: Company; Sharekhan Research

Revenue in-line, margins beat estimates: HCL Tech reported largely in-line revenue performance, while EBIT margin and net profit beat our estimates. Constant currency (CC) revenue declined 7.2% q-o-q, broadly in-line with our estimates, owing to supply-side constraints due to COVID-19 (1/3rd of total revenue impact from COVID) and reduction of revenue from offshoring of a large deal. Mode-1 and Mode-3 services revenue declined 9.5% and 1.6% in CC terms, respectively, Mode-2 service revenues declined by 1.6% q-o-q. USD revenues declined 7.4% q-o-q to \$2,355.5 million during the quarter. EBIT margin contracted 36bps q-o-q to 20.5%, beating our estimates, led by rupee tailwinds, cost management, right shoring, automation and a change in the mix of business. The margin headwinds were increased depreciation and amortization owing to its investments (-67bps), R&D expenditure (-12bps), revenue decline (-70bps), which was partially offset by benefits from rupee depreciation (+76bps) and reduction in travel expenses (+40bps). Net profit of Rs. 2,923 crore (down 7.3% q-o-q) was 8.6% ahead of our estimates aided by higher profitability and higher other income (includes sale of land parcel of \$14.4 million).

Reinstated guidance, expect positive q-o-q growth for the remaining quarters of FY2021: Management indicated that the business impact due to COVID-19 has remained lower compared to what was anticipated at the beginning of the year. Hence, the management provided its guidance on revenue growth in the range of 1.5% - 2.5% q-o-q for the remaining quarters of FY2021. This guidance translates to negative 3.3% to negative 0.8% growth in FY2021. On the margin front, the management expects EBIT margin to be in the range of 19.5-20.5% for FY2021 (EBIT margin was at 19.6% in FY2020). Management remains confident on sequential growth for the remaining quarters of FY2021 on the back of strong deal wins, healthy deal pipeline, traction for infra business (cloud migration projects), higher demand for HCL software products with limited impact from COVID-19 and increasing spending on digital transformation works. Management sees stability in lifesciences and healthcare, financial service, technology and telecom verticals, which performed quite well during Q1FY2021. Management also highlighted that COVID-19 related impact on the demand side stabilized after the initial impact of ramp-downs, volume reduction and discounts to some customers in the stressed sectors.

Q1FY2021 Result key highlights from earnings call

- ♦ **Reinstated guidance:** Management highlighted that resilience in operating model, portfolio mix, and relationship with customers beyond contract helped the company ride through this pandemic. It expects revenue to increase q-o-q by an average of 1.5%-2.5% in CC for the next 3 quarters, implies a revenue decline of -3.3% to -0.8% for FY2021. The management believes that the growth for the remaining quarters of FY2021 would be supported by strong order bookings and a healthy deal pipeline. Management expects EBIT margin to be in the range of 19.5%-20.5% for FY2021 as against EBIT margin of 19.6% in FY2020.
- ♦ **IT and business services** revenue declined 7.8% on CC owing to significant revenue decline from the directly impacted verticals such as manufacturing, retail, travel, hospitality and media. Lifesciences and healthcare, financial service, technology and telecom performed quite well during the quarter.
- ♦ **Engineering and R&D services** revenue declined 9% q-o-q on CC, owing to significant revenue loss from directly impacted segments like aerospace, automobiles and office automation. The revenue decline also includes the revenue decline from the offshoring of large deals during the quarter.
- ♦ **Deal Bookings in IT and business services and ERD services** were healthy. This provides revenue growth visibility for the remaining period of the year.
- ♦ **Products and Platform revenue** A decline of 2.1% CC was less compared to IT and business unit and ERD services. Over the last 12 months, HCL Tech completed over 16,500 sales transactions across 11,000 unique customers and onboarded more than 2,400 partners and reseller. The company released new products across portfolio. HCL Tech added 250+ new customers during last one year including 100+ in last quarter alone. The transition remains on track. COVID-19 impact has been very limited in this P&P segment, supported by building relationships beyond contract with customers, diversification across industries and geographies and new demand ecommerce, digital experience and security. Management remains cautiously optimistic for the P&P business segment. Over the last three quarters, the run-rate of incremental revenue in P&P business is around 600 million on CC basis. This is tracking well with the company's earlier guidance of \$625 million first 12 months.

- ♦ **IMS business:** The management indicated that higher adoption of cloud is a tailwind for its infrastructure business. Enterprises are looking cloud adoption, digital infrastructure including cyber security, network management, automation led operation model, which would create good opportunities for HCL Tech.
- ♦ **Strong deal closures:** The deal closures have been decent in Q1FY2021. HCL Tech signed 11 new transformational deals, led by key industry verticals including telecommunication, financial services, manufacturing, life sciences and healthcare. The company's bookings TCV (net new deals) is higher on y-o-y basis and the renewals were also robust during the quarter. The company won a large consolidation opportunity in Europe and the revenue from this opportunity will ramp-up gradually over next few quarters.
- ♦ HCL Tech expanded its preferred services partnership with Broadcom Inc., broadening its professional services offerings to include Symantec Enterprise Division (SED) consulting services.
- ♦ **Strong deal pipeline:** HCL Tech's management indicated that the deal pipeline has increased 40% q-o-q during the quarter. Management sees a healthy deal pipeline in lifesciences, financial services, technology, energy and auto segments. Two broad themes such as (1) momentum in cost transformation and vendor consolidation deal (especially in energy and auto) and (2) acceleration in digital transformation (cloud, digital work place and cyber security) are playing out. The management witnessed a good deal creation activity in existing clients, which will create opportunities for the company.

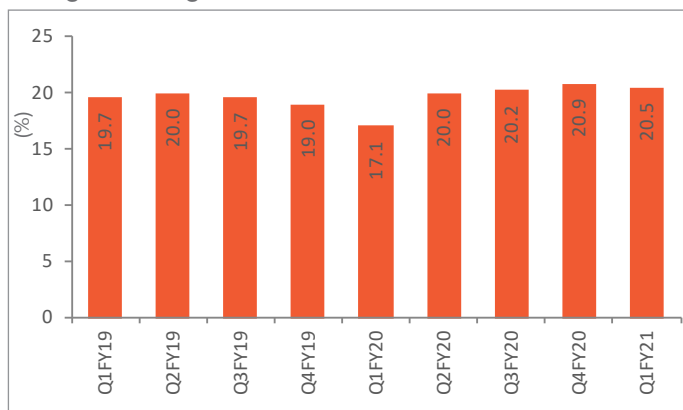
Results	Rs cr				
Particulars	Q1FY21	Q1FY20	Q4FY20	y-o-y (%)	q-o-q (%)
Revenue (\$ mn)	2,355.5	2,363.6	2,543.4	-0.3	-7.4
Net sales	17,841.0	16,425.0	18,590.0	8.6	-4.0
Direct costs	10,728.0	10,631.0	11,151.0	0.9	-3.8
Gross profit	7,113.0	5,794.0	7,439.0	22.8	-4.4
SG&A	2,205.0	2,105.0	2,391.0	4.8	-7.8
EBITDA	4,908.0	3,689.0	5,048.0	33.0	-2.8
Depreciation and amortisation	906.0	595.0	839.0	52.3	8.0
EBIT	4,002.0	3,094.0	4,209.0	29.3	-4.9
Forex gain/(loss)	0.0	19.0	-36.0	-	-
Other income	205.0	109.0	23.0	88.1	791.3
PBT	4,207.0	3,222.0	4,196.0	30.6	0.3
Tax provision	929.0	705.0	707.0	31.8	31.4
Net profit	2,923.0	2,220.0	3,153.0	31.7	-7.3
EPS (Rs.)	10.8	8.2	11.6	31.7	-7.3
Margin (%)				BPS	BPS
EBITDA	27.5	22.5	27.2	505	36
EBIT	22.4	18.8	22.6	359	-21
NPM	16.4	13.5	17.0	287	-58

Source: Company; Sharekhan Research

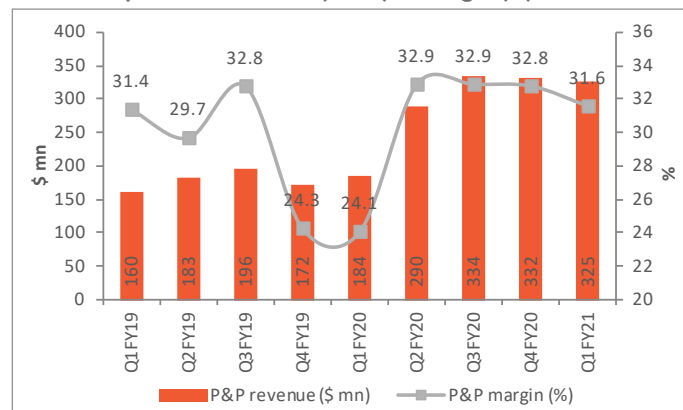
Operating metrics

Particulars	Revenues	Contribution	\$ Growth (%)		CC growth (%)	
	(\$ mn)	(%)	q-o-q	y-o-y	q-o-q	y-o-y
Revenues (\$ mn)	2,356	100	-7.4	-0.3	-7.2	1.0
Geographic mix						
Americas	1,500	63.7	-6.9	-6.2	-6.9	-5.8
Europe	667	28.3	-8.7	8.9	-8.5	11.4
RoW	188	8.0	-5.0	26.5	-5.1	31.2
Industry verticals						
Financial services	528	22.4	-1.7	10.0	-1.7	11.7
Manufacturing	426	18.1	-19.0	-9.4	-18.8	-8.3
Technology & services	405	17.2	-1.7	-9.3	-1.2	-8.8
Retail & CPG	236	10.0	-9.2	4.9	-9.0	6.7
Telecommunications, media, publishing & entertainment	108	27.7	-4.4	9.5	-4.1	10.6
Lifesciences & healthcare	179	7.6	-15.2	-5.3	-15.5	-4.4
Lifesciences & healthcare	323	13.7	1.5	6.7	1.9	7.1
Public services	259	11.0	-8.2	4.4	-7.1	7.0
Service line						
IT and business services	1,654	70.2	-7.9	0.0	-7.8	-5.6
Engineering and R&D Services	377	16.0	-9.1	0.0	-9.0	-5.1
Products & platforms	325	13.8	-2.4	0.0	-2.1	77.7
Clients Contribution						
Top 5	327	13.9	-14.7	-16.6	-	-
Top 10	492	20.9	-12.0	-12.9	-	-
Top 20	725	30.8	-11.1	-10.3	-	-

Source: Company; Sharekhan Research

Strong EBIT margin defense


Source: Company, Sharekhan Research

Product & platform revenue (\$ mn) & margin (%)


Source: Company, Sharekhan Research

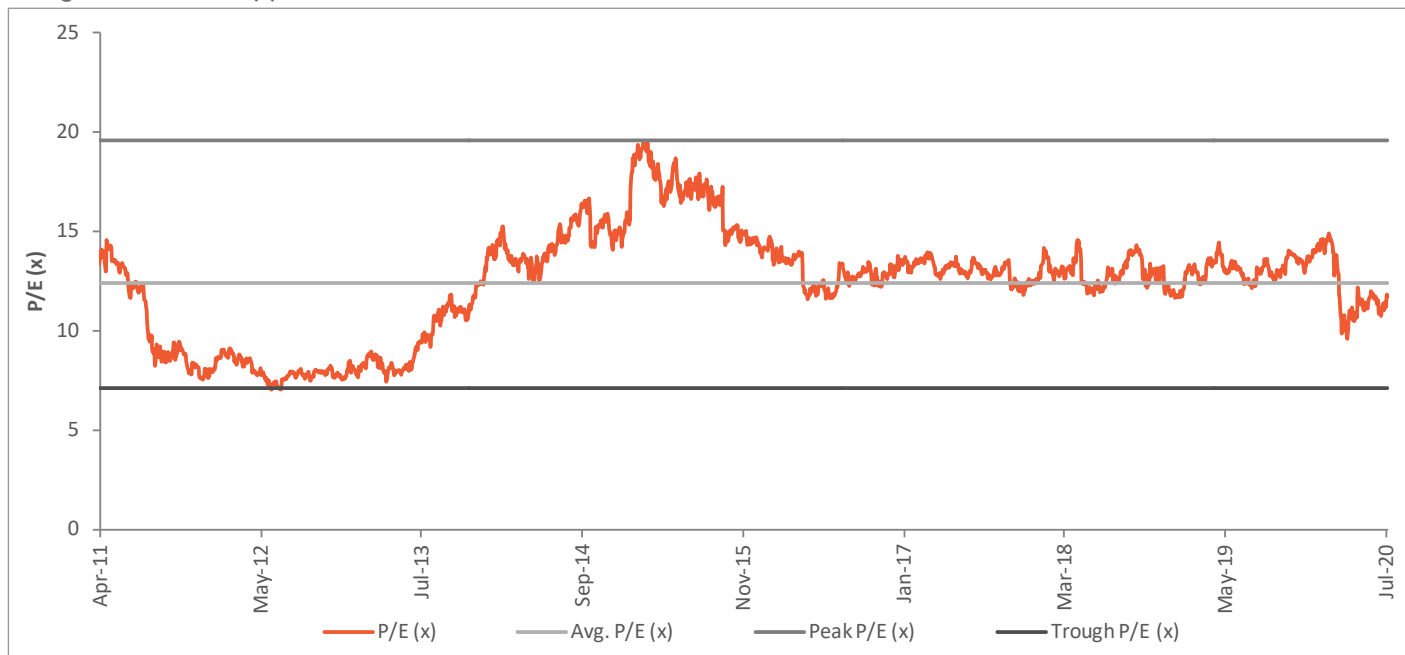
Outlook

Gartner estimates IT services spending would decline around 6.8% worldwide in 2020 due to COVID-led business disruption. However, the management highlighted that COVID-19 related impact on the demand side stabilized after initial impact of ramp-downs, volume reduction and discounts to some customers in the stressed sectors given its large deal wins, healthy deal pipeline and limited impact on its P&P business. HCL Tech has invested aggressively in the fast-growing Mode-2 (a good proxy for digital offering) capabilities, which would help HCL Technologies to match 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 information management services (IMS) is huge with only 10-12% penetration of addressable market. Given its differentiated positioning in IMS and strong capabilities in engineering services, HCL Technologies is well positioned to maintain growth momentum in these segments going ahead.

Valuation

Maintain Buy with revised PT of Rs. 750: We have revised our earnings estimates upward for FY2021E/FY2022E, to factor in better-than-expected margin performance in Q1FY2021 and commentary on stabilization of demand-side impact owing to COVID-19. Strong order flows and vendor consolidation would help the company to return to sequential positive growth trajectory. Robust demand for managed services on cloud platforms and emergence of new business models for deeply impacted verticals would create opportunities for the company. At CMP, the stock trades at 15x/14x of its FY2021E/FY2022E earnings. The company has impressed with consistent wins of large deals, strong FCF generation and good margin defense. We maintain our Buy rating on the stock with a revised PT of Rs. 750.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer comparison

Particulars	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)		EV/EBIDTA (x)		P/BV (x)		RoE (%)	
				FY21E	FY22E	FY21E	FY22E	FY21E	FY22E	FY21E	FY22E
Infosys	904	424	385,028	22.6	20.3	14.8	13.3	3.2	3.1	25.9	28.5
Wipro	262	570	149,433	16.3	14.9	4.5	3.9	2.6	2.4	13.9	14.0
TCS	2,201	375	826,031	27.5	24.3	20.1	18.1	10.0	9.7	35.9	40.6
HCL Tech	623	271	169,183	15.0	13.8	4.6	4.3	3.0	2.7	20.9	20.4

Source: Company, Sharekhan Research

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	Vanguard Group Inc/The	1.49
2	Artisan Partners LP	1.48
3	BlackRock Inc	1.39
4	SBI Funds Management Pvt Ltd	1.30
5	Life Insurance Corp of India	1.11
6	ICICI Prudential Asset Management	1.08
7	Vontobel Holding AG	0.97
8	Virtus Investment Partners Inc	0.95
9	Nomura Holdings Inc	0.87
10	Lazard Limited	0.65

Source: Bloomberg

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