Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

HCL Technologies

Bright future ahead

IT & ITES	Sharekhan code: HCLTECH	Company Update

3R MATRIX	+	=	-
Right Sector (RS)	✓		
Right Quality (RQ)	✓		
Right Valuation (RV)	✓		

\+ Positive = Neutral - Negative

What has changed in 3R MATRIX

	Old		New
RS		↔	
RQ		↔	
RV		↔	

Reco/View	Change
Reco: **Buy**	↔
CMP: **Rs. 802**	
Price Target: **Rs. 900**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

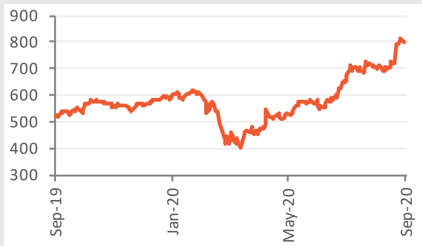
Company details

Market cap:	Rs. 2,17,717 cr
52-week high/low:	Rs. 849 / 375
NSE volume: (No of shares)	65.9 lakh
BSE code:	532281
NSE code:	HCLTECH
Free float: (No of shares)	54.3 cr

Shareholding (%)

Promoters	60.3
FII	26.1
DII	10.6
Others	3.0

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	13.7	40.9	92.4	55.4
Relative to Sensex	15.7	32.0	46.0	58.1

Sharekhan Research, Bloomberg

Summary

- We maintain our Buy rating on HCL Technologies (HCL Tech) with a revised PT of Rs. 900.
- Mid-quarter update raises revenue and margin guidance for Q2FY2021, driven by better-than-expected execution, pick-up in discretionary spends that were held up, and return of normalcy in certain pockets.
- Given strong capabilities in IMS, HCL Tech would continue to win consolidation deals with application components; The acquisition of DWS would further expand its digital offerings, especially in the APAC region.
- With no pending IBM-IP acquisition-related payments along with limited capex obligations, we expect free cash flow generation to improve going forward, which could lead to improvement in payout ratio.

HCL Technologies (HCL Tech) recently released its mid-quarter update on its business performance. The company expects to deliver better than the top end of its earlier guidance on both revenue and operating profitability. The company expects revenue growth to exceed 3.5% q-o-q on CC terms (versus previous guidance of 1.5-2.5%) and operating profit margin (OPM) of 20.5-21% (versus its earlier guided band of 19.5-20.5%). Improved outlook was driven by (1) strong execution across verticals and geographies, (2) pick up in deals or discretionary spends that were held up by clients, and (3) return of normalcy in manufacturing and ecommerce segments and supply-side constraints earlier than expectations. In addition, the company indicated 11 new transformational deals across the telecom, manufacturing, life sciences, and healthcare verticals and solid deal pipeline (up 40% q-o-q) in Q1FY2021. Hence, some deals that were in transition have started flowing into the current quarter. The COVID-19 pandemic has accelerated digital activities among large global enterprises, leading to a rise in spending on workplace transformation and collaboration tools, cybersecurity, and higher cloud migration. Given strong capabilities in IMS, HCL Tech would continue to win consolidation deals with application components. HCL Tech announced the acquisition of DWS Limited (DWS) at A$1.20 per share, translated to total equity value pay-out of US$115 million (0.9x of EV/sales). We believe this acquisition would further expand its digital offerings especially in the APAC region.

Our Call

Valuation – Maintain Buy with a revised PT of Rs. 900: Most managements of IT companies indicated higher spending on transformational works to improve business resiliency, emergence of new business models, and cost-takeout initiatives. We believe HCL Tech's infra and application capabilities are expected to drive its growth in this cloud adoption environment. Further, increased revenue and margin guidance for Q2FY2021 has surprised us positively. We have incorporated the revised growth and margin outlook in our FY2021/ FY2022/FY2023 guidance, leading to an EPS upgrade of 3.8%/3.4%/4%, respectively. Strong order bookings, healthy deal pipeline, and consolidation opportunities in both IMS and application modernisation spend of clients are expected to drive the company's growth going forward. HCL Tech's gross cash stood at $1,950 million as of Q1FY2020 after payment of IBM obligation of $813 million. With no pending IBM-IP acquisition related payments along with limited capex obligations, free cash flow (FCF) generation would improve going forward, which could lead to improvement in payout ratio. At the CMP, the stock trades at 17x/15x its FY2022E/FY2023E 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. 900.

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.

Valuations Rs cr

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenue	60,427.0	70,678.0	73,292.0	80,967.7	87,410.3
OPM (%)	23.1	23.6	25.5	24.8	24.5
Adjusted PAT	10,123.0	11,061.0	11,909.5	13,074.1	14,184.7
% YoY growth	*15.3*	*9.3*	*7.7*	*9.8*	*8.5*
Adjusted EPS (Rs.)	36.8	40.8	43.9	48.2	52.3
P/E (x)	21.8	19.7	18.3	16.6	15.3
P/B (x)	2.8	4.2	3.8	3.4	3.4
EV/EBITDA (x)	7.7	6.5	5.8	5.4	5.0
RoNW (%)	26.0	23.8	21.9	21.7	22.3
RoCE (%)	29.2	25.3	24.0	24.1	25.0

Source: Company; Sharekhan estimates

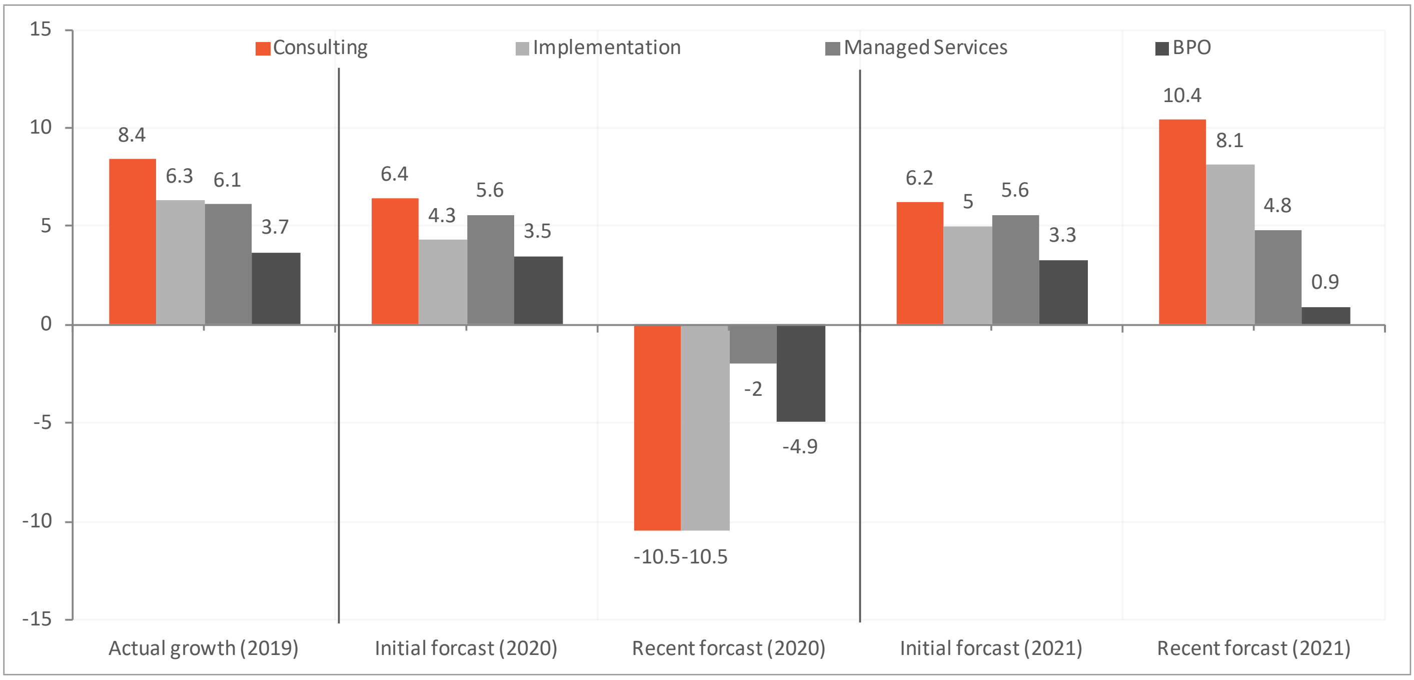
Technology intensity rising steadily

Implications from the COVID-19 outbreak have accelerated digital activities among large global enterprises, leading to a rise in spending on workplace transformation and collaboration tools, cybersecurity, and higher cloud migration. As technology is seen as a source of competitive differentiation in every industry, we believe technology spend is expected to increase once the situation normalises.

Industry analysts have estimated IT services spending growth to decline by 2-10% for CY2020 and subsequent recovery in CY2021. Despite a recessionary environment, most managements of IT companies also indicated higher spending on transformational works to improve business resiliency, emergence of new business models, and cost-takeout initiatives. The Indian IT services sector is expected to enter into high-growth phases because of (1) higher core modernisation to build business resiliency, (2) higher cloud adoption, and (3) increased online activities considering social distancing measures.

Total spending in IT, business services, engineering, and R&D is expected to increase to $3.5 trillion over the next few years from current spending of $2.5 trillion. We believe HCL Tech is well positioned to take this market opportunity of $1 trillion.

IT services spend to recover in CY2022



Source: Gartner, Sharekhan Research

Infrastructure and application opportunity likely to drive its growth

HCL Tech's management indicated that infra and applications were managed separately. Higher cloud adoption has increased the demand for both infra and application from the same vendor. HCL Tech has strong capabilities in IMS and has won consolidation deals with application components. During Q1FY2021, the company consolidated two providers who were providing workplace and data centre services and application separately. We believe infra and application opportunities would be the company's growth drivers going ahead.

Mid-quarter update indicates improved outlook

HCL Tech has provided mid-quarter update on its business performance, wherein the company highlighted improved outlook by guiding for better-than the top end of its earlier guidance for Q2FY2021E. The company expects revenue growth to exceed 3.5% q-o-q on CC terms versus previous guidance of 1.5-2.5% and OPM of 20.5-21% versus its earlier guided band of 19.5-20.5%. The upgradation of revenue growth for Q2FY2021 was led by (1) strong execution across verticals and geographies, (2) pick up in deals or discretionary spends that were held up by clients, and (3) return of normalcy in manufacturing and ecommerce segments and supply-side constraints earlier than expectations. Management indicated that strong growth in revenue and lower continued expenses on travel and admin would help in margin improvement. HCL Tech indicated good order booking momentum, led by life sciences and healthcare, telecom and media, and financial services verticals and a healthy deal pipeline across service lines, verticals, and geographies.

Acquired DWS Limited to expand its presence in APAC

HCL Tech announced the acquisition of Australian IT firm DWS Limited (DWS) to further expand its digital offerings, especially in Australia and New Zealand. HCL Tech is acquiring DWS at A$1.20 per share (33% premium to the closing price of DWS on September 18, 2020), translated to total equity value payout of A$158.2 million (US$115 million) after considering total number of shares at 131.8 million on a fully diluted basis. The deal is likely to complete by December 2020 subject to regulatory approvals. DWS has over 700 employees. DWS reported annual revenue of A$167.9 million (US$122 million, which is 1.2% of HCL Tech's FY2020 revenue) in FY2020 (June ending), which registered 2.7% growth. DWS's EBITDA margin for FY2019 and FY2020 stood at 13.2% and 12.2%, respectively, which is much lower than its own guided range. However, management indicated that acquisition of DWS would not have any impact on the company's overall EBITDA margin.

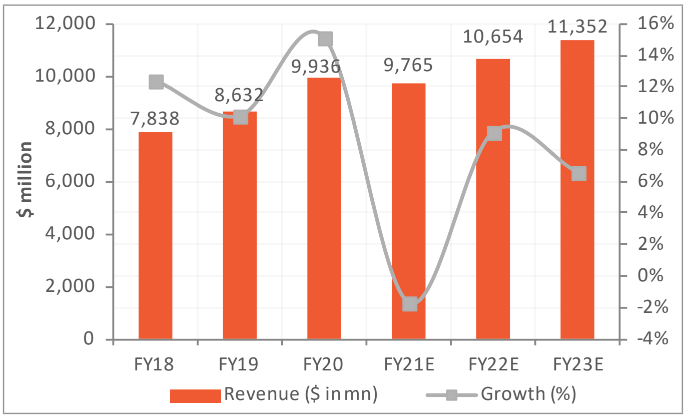
DWS's financial performance **in A$ million**

Particulars	FY16	FY17	FY18	FY19	FY20
Revenue	144.5	137.4	126.1	163.5	167.9
Growth (%)	52.7	-4.9	-8.3	29.7	2.7
EBITDA	24.2	25.8	20.5	21.5	20.5
EBITDA margin (%)	16.8	18.8	16.2	13.2	12.2
EBIT	23.8	25.3	20.1	19.6	NA
EBIT margin (%)	16.5	18.4	15.9	12.0	NA
Net profit	16.8	17.4	15.9	10.3	7.5
EPS (cents)	12.7	13.2	12.1	7.8	5.7
Growth (%)	61.9	3.6	-8.3	-35.5	-26.9

Source: DWS Limited, Sharekhan Research

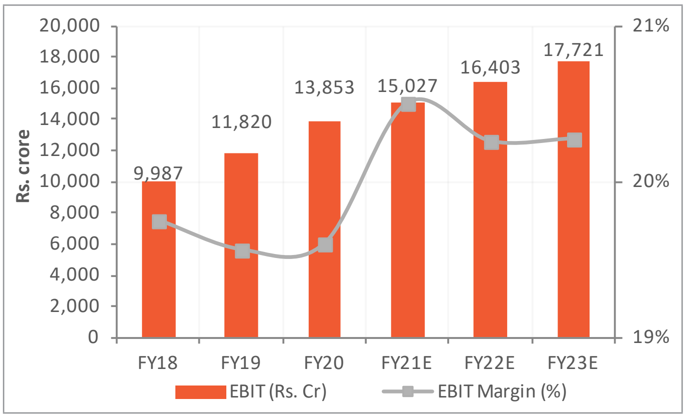
Financials in charts

Revenue in US$ (mn) and growth (%)



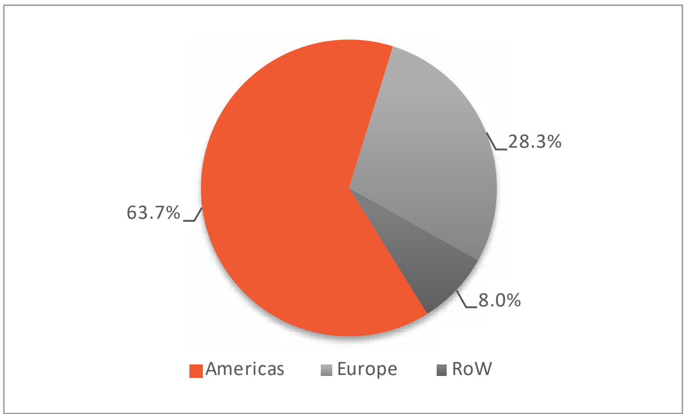
Source: Company, Sharekhan Research

EBIT (Rs. cr) and EBIT margin (%)



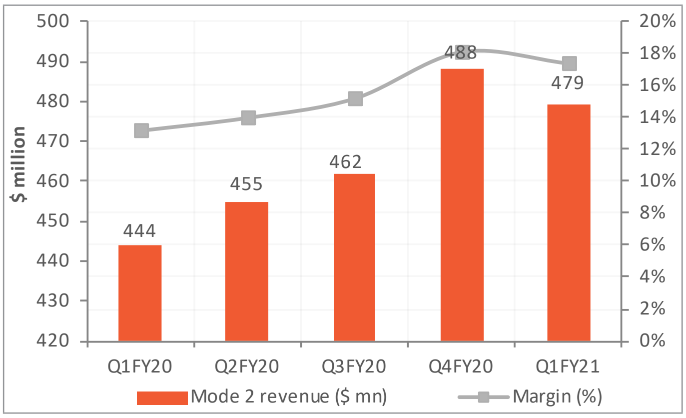
Source: Company, Sharekhan Research

Geograpghy break-up (%)



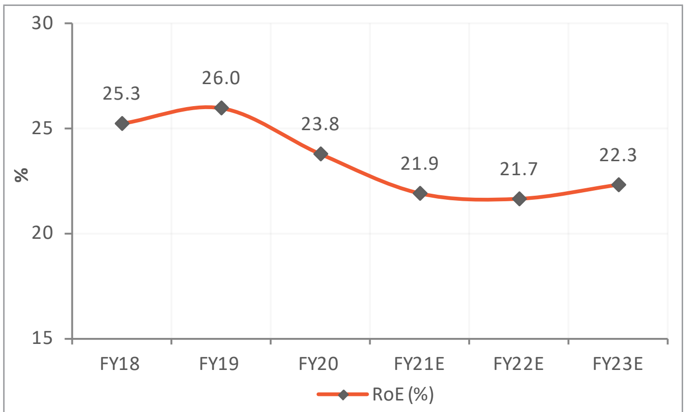
Source: Company, Sharekhan Research

Mode 2 revenue and margin (%)



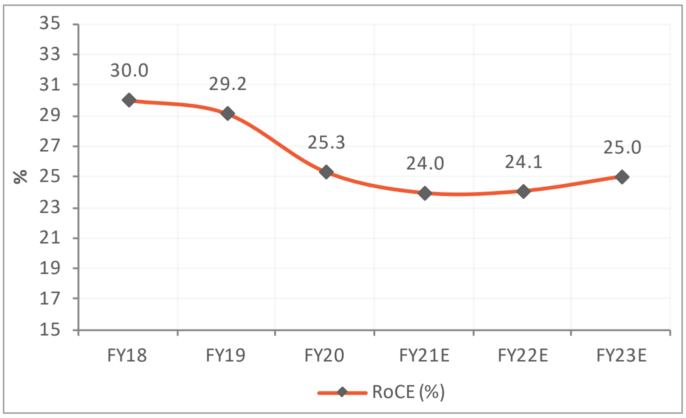
Source: Company, Sharekhan Research

RoE trend (%)



Source: Company, Sharekhan Research

RoCE trend (%)



Source: Company, Sharekhan Research

Outlook and Valuation

■ **Sector view – Expect acceleration in technology spending going forward:** Industry analysts such as Gartner estimate IT services spending would grow by 5-8% over CY2021-CY2024E compared to average of 4.2% achieved in CY2010-CY2019. Forecasts indicate higher demand for cloud infrastructure services, potential increase in specialised software, potential investments in transformation projects by clients, and increased online adoption across verticals. Implications from the outbreak of the pandemic have accelerated digital activities among large global enterprises, leading to increased spending on workplace transformation and collaboration tools, cyber-security, and higher cloud migration. Higher hybrid cloud adoption is a good tailwind for IMS business as the client would invest in digital foundation (includes security and an automated operating model) and application modernisation.

■ **Company outlook - Growth recovery ahead:** HCL Tech's management has raised its revenue and margin guidance for Q2FY2021 as COVID-19 impact on demand side has stabilised and order book along with the deal pipeline remains strong. Further, HCL Tech has invested aggressively in the fast-growing Mode-2 (a good proxy for digital offering) capabilities, which would help HCL Tech to match the industry's growth. 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 huge, with only 10-12% penetration of the 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 - Maintain Buy with a revised PT of Rs. 900:** Most managements of IT companies indicated higher spending on transformational works to improve business resiliency, emergence of new business models, and cost-takeout initiatives. We believe HCL Tech's infra and application capabilities are expected to drive its growth in this cloud adoption environment. Further, higher Q2FY2021 revenue and margin guidance has surprised us positively. We incorporate the revised growth and margin outlook in our FY2021/FY2022/FY2023 guidance, leading to an EPS upgrade of 3.8%/3.4%/4%, respectively. Strong order bookings, healthy deal pipeline, consolidation opportunities in both IMS and application modernisation spend of clients are expected to drive the company's growth going forward. HCL Tech's gross cash stood at $1,950 million as of Q1FY202 after payment of IBM obligation of $813 million. With no pending IBM-IP acquisition related payments along with limited capex obligations, FCF generation would improve going forward, which could lead to improvement in payout ratio. At the CMP, the stock trades at 17x/15x its FY2022E/FY2023E 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. 900.

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
Wipro	312	571	178,292	18.1	17.2	4.9	4.4	3.1	2.9	15.6	15.5
TCS	2,461	375	923,913	29.5	26.2	22.0	19.9	11.1	11.5	37.4	43.0
Tech M	786	97	75,968	18.9	15.1	10.8	8.3	2.8	2.6	15.7	17.8
HCL Tech	804	271	217,500	19.0	17.2	6.0	5.6	3.8	3.5	21.2	21.1

Source: Company, Sharekhan estimates

About company

HCL Tech is a leading global technology company providing software-led IT solutions, remote infrastructure management, 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 IMS. 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 deals. Strong deal wins along with acquisition of select IP products will help the company 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 US 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	SBI Funds Management Pvt Ltd	2.05
2	Life Insurance Corp of India	1.81
3	Artisan Partners LP	1.53
4	Vanguard Group Inc/The	1.44
5	BlackRock Inc	1.31
6	Virtus Investment Partners Inc	0.95
7	ICICI Prudential Asset Management	0.94
8	Nomura Holdings Inc	0.86
9	Vontobel Holding AG	0.76
10	Norges Bank	0.64

Source: Bloomberg

Understanding the Sharekhan 3R Matrix

Right Sector	
Positive	Strong industry fundamentals (favorable demand-supply scenario, consistent industry growth), increasing investments, higher entry barrier, and favorable government policies
Neutral	Stagnancy in the industry growth due to macro factors and lower incremental investments by Government/private companies
Negative	Unable to recover from low in the stable economic environment, adverse government policies affecting the business fundamentals and global challenges (currency headwinds and unfavorable policies implemented by global industrial institutions) and any significant increase in commodity prices affecting profitability.
Right Quality	
Positive	Sector leader, Strong management bandwidth, Strong financial track-record, Healthy Balance sheet/cash flows, differentiated product/service portfolio and Good corporate governance.
Neutral	Macro slowdown affecting near term growth profile, Untoward events such as natural calamities resulting in near term uncertainty, Company specific events such as factory shutdown, lack of positive triggers/events in near term, raw material price movement turning unfavourable
Negative	Weakening growth trend led by led by external/internal factors, reshuffling of key management personal, questionable corporate governance, high commodity prices/weak realisation environment resulting in margin pressure and detoriating balance sheet
Right Valuation	
Positive	Strong earnings growth expectation and improving return ratios but valuations are trading at discount to industry leaders/historical average multiples, Expansion in valuation multiple due to expected outperformance amongst its peers and Industry up-cycle with conducive business environment.
Neutral	Trading at par to historical valuations and having limited scope of expansion in valuation multiples.
Negative	Trading at premium valuations but earnings outlook are weak; Emergence of roadblocks such as corporate governance issue, adverse government policies and bleak global macro environment etc warranting for lower than historical valuation multiple.

Source: Sharekhan Research

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