

## Digital & product business drove margins....

HCL Technologies (HCL) reported healthy margins in Q3FY21 and were above our estimates. The company has also revised its margins guidance upwards from 20-21% in FY21E to 21-21.5%. Revenues were in line with our estimate at 3.5% QoQ in CC terms, while margins were above our estimates. HCL has signed 13 transformational deals across industry verticals, including Life Sciences and Healthcare, Technology and Financial Services. The company has declared a dividend of ₹ 4/share.

## Cloud, products and large deals to drive growth

HCL Tech witnessed a healthy quarter mainly led by traction in cloud, digital and product business. Going forward, we expect HCL Technologies to be a key beneficiary of growing opportunities in cloud, app & platform modernization and cybersecurity. The company's expertise in Infrastructure Management Services (IMS) and app modernisation can witness phenomenal growth led by integrated deals in cloud. HCL Tech also witnessed healthy traction in deal TCY (up 13% YoY) and deal pipeline. This coupled with improvement in product business (led by new license sale, new logos and cross sell opportunities with services) will further boost growth. In addition, improvement in large deal wins, inorganic growth and opportunities in captive carve outs makes us positive in company's revenue trajectory in long term. Hence, post a 2.7% YoY growth in FY21E dollar revenues we expect the company to clock 12.0% and 11.5% YoY growth in FY22E & FY23E, respectively.

## Higher offshoring to keep margins buoyant

The company expects partial impact of wage hike of 80-90 bps in Q4FY21E, absence of one off (60 bps) and adverse mix of product seasonality as key headwinds to margins. Hence, expects margins to be in the range of 21-21.5% in FY21E. Despite considering these headwinds we expect the company to easily surpass top end of guided margins in FY21E. In the long term the company expects margin headwinds in terms of reduction of covid savings (100 bps) and higher SG&A expenses to drive growth in cloud & product business. However, we believe higher offshoring and revenue growth will help in boosting margins leading to a margin expansion of 60 bps to 22.2% over FY21E-FY23E.

## Valuation & Outlook

We believe HCL Tech is in a sweet spot to capture demand traction in cloud and cloud related services considering its strength in IMS business & partnership with hyperscalers. In addition, better capital allocation and healthy margin trajectory makes us positive on the stock from a long term perspective. Hence we maintain **BUY** on the stock with a target price of ₹ 1150 (18x PE on FY23E EPS) (previous target was ₹ 1105).

### Particulars

Particular	Amount
Market Cap (₹ Crore)	2,68,324.2
Total Debt (₹ Crore)	4,693.0
Cash & Equivalents (₹ Crore)	11,965.0
EV (₹ Crore)	2,61,052.2
52 week H/L	1073 / 375
Equity capital	543.0
Face value	₹ 2

### Key Risk

- The recently acquired products from IBM require higher investment. If the company is unable to scale these business adequately it will adversely impact its revenues.
- We assume that acceleration in digital technologies will drive revenue growth of IT companies. However, a slower than expected pace of growth in digital technologies will impact HCL Tech's revenue growth.

### Research Analyst

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### Key Financial Summary

Key Financials	FY19	FY20	FY21E	FY22E	FY23E	CAGR FY(20-23E)
Net Sales	60,427	70,678	75,758	84,552	95,549	10.6%
EBITDA	13,968	16,694	19,977	22,322	25,225	14.8%
Margins (%)	23.1	23.6	26.4	26.4	26.4	
Net Profit	10,122	11,062	13,413	14,729	17,044	15.5%
EPS (₹)	37.3	40.8	49.4	54.3	62.8	
P/E	26.5	24.3	20.0	18.2	15.7	
RoNW (%)	24.5	21.6	21.9	20.8	20.6	
RoCE (%)	26.9	23.0	24.0	24.3	24.7	

Source: Company, ICICI Direct Research

**Exhibit 1: Variance Analysis**

	Q3FY21	Q3FY21E	Q3FY20	YoY (%)	Q2FY21	QoQ (%)	Comments
Revenue	19,302	19,242	18,135	6.4	18,594	3.8	The company's dollar revenues increased by 3.5% QoQ (in cc terms) mainly led by Technology & services (up 6.8% QoQ), Retail (up 3.7% QoQ) Manufacturing (up 5.6% QoQ) and Telecommunication (up 12.1% QoQ)
Cost of sales (including employee expenses)	11,551	11,834	11,510	0.4	11,279	2.4	
Gross Margin	7,751	7,408	6,625	17.0	7,315	6.0	
Gross margin (%)	40.2	38.5	36.5	362 bps	39.3	82 bps	
Selling & marketing costs	2,309	2,501	2,155	7.1	2,364	-2.3	
EBITDA	5,443	4,907	4,470	21.8	4,951	9.9	
EBITDA Margin (%)	28.2	25.5	24.6	355 bps	26.6	157 bps	
Depreciation	1,027	935	800	28.4	935	9.8	
EBIT	4,416	3,972	3,670	20.3	4,016	9.9	
EBIT Margin (%)	22.9	20.6	20.2	264 bps	21.6	128 bps	Margin increase was led by higher offshoring (~50 bps), SG&A leverage (70 bps), one offs like provisions (60 bps) partially offset by wage hike (50 bps) and higher depreciation expenses
Other income	126	136	67	NA	136	-7.4	
PBT	4,542	4,108	3,737	21.5	4,152	9.4	
Tax paid	544	999	691	-21.3	999	-45.5	The decline in tax expenses was due to reversal of provision for an uncertain tax position set-up in prior years
PAT	3,982	3,098	3,038	31.1	3,142	26.7	PAT was above our estimates mainly due to higher than expected operating margins & lower tax expenses

Source: Company, ICICI Direct Research

**Exhibit 2: Change in estimates**

	FY21E			FY22E			FY23E			Comments
(₹ Crore)	Old	New	% Change	Old	New	% Change	Old	New	% Change	
Revenue	75,346	75,758	0.5	85,517	84,552	-1.1	96,207.0	95,549	-0.7	We expect revenues to improve in coming quarters on back of traction in cloud and product revenues
EBIT	15,933	16,387	2.8	18,429	18,537	0.6	21,099.7	21,236	0.6	
EBIT Margin (%)	21.1	21.6	48 bps	21.6	21.9	37 bps	21.9	22.2	29 bps	Expect margins to stabilise at 22.2% in FY23E
PAT	12,376	13,413	8.4	14,420	14,729	2.1	16,620.9	17,044	2.5	
EPS (₹)	45.6	49.4	8.4	53.2	54.3	2.1	61.3	62.8	2.5	

Source: Company, ICICI Direct Research

## Conference Call Highlights

- Revenue outlook** – In Q3FY21, the company saw healthy revenue growth. The growth was driven by a robust momentum in Mode 2 and Mode 3 businesses led by digital, cloud and products & platform segments. The company's total contractual value increased 13% YoY and expects robust pipeline. The company's 60% of its pipeline is in large deals and expects multiple opportunity in US\$200-300 million deals. In terms of verticals manufacturing, healthcare and retail are gaining traction. The company is seeing healthy growth in customer experience, data & analytics, cloud, platform modernisation and re-imagination of supply chain. HCL's strong infrastructure prowess & partnership with hyperscalers will make it a key beneficiary of transition to cloud and then an end to end execution on app modernisation & customer experience. In terms of products, the company is seeing healthy traction in new licence (new deal TCV is up 2x to US\$90 million) and has added 350 new clients. The company is also seeing cross sell opportunities in services and products business. In ER&D, the company expects gradual recovery in terms of growth and sees traction in software engineering services, ADAS & 5G partially offset by asset heavy industry like aerospace which has impacted ER&D.
- Margin walk through** - On the margin front, the margin increased 128 bps on the back of higher offshoring (~50 bps), SG&A leverage (70 bps), one offs like provisions (60 bps) partially offset by wage hike (50 bps) and higher depreciation expenses. The company expects partial impact of wage hike of 80-90 bps in Q4FY21E and absence of one off (60 bps) and adverse mix of product seasonality as key headwinds to margins. Hence, expects margins to be in the range of 21-21.5% in FY21E. Despite considering these headwinds we expect the company to easily surpass top end of guided margins in FY21E. In the long term the company expects margin headwinds in terms of reduction of covid savings (100 bps) and higher SG&A expenses to drive growth in cloud & product business. However, we believe higher offshoring and revenue growth will help in boosting margins leading to a margin expansion of 60 bps to 22.2% over FY21E-FY23E.
- Mode 2, 3** - The IBM products acquisition is reflected in Mode 3 business. Mode 2 (digital business) and mode 3 (product business), which are into newer age technologies, together constituted ~39% of revenues. Mode 2 revenues increased 10.9% QoQ mainly led by cloud native & digital program and Mode 3 revenues increased 7.1% QoQ mainly led by new license & renewals. In terms of margins, Mode 2 margins improved 350 bps QoQ to 22.0% and Mode 3 margins increased 100 bps QoQ to 29.7%
- Acquisition** - The company has acquired DWS Ltd for A\$158.2 million and had a revenue of A\$167.9 million. The company has completed the acquisition on 5 January 2021 and we believe could add 1% to revenues.
- Employees** – HCL saw an addition of 6597 employees (of which 90% are offshore hiring) in Q3FY21, taking its overall full-time employee headcount to 159,682. Localisation in the quarter stood at 69.8%.

## Key Metrics

### Exhibit 3: Geography wise break-up

	Q3FY20	Q4FY20	Q1FY21	Q2FY21	Q3FY21
<b><u>Revenue by geography (%)</u></b>					
Americas	62.8	63.4	63.7	63.1	62.5
Europe	29.2	28.7	28.3	28.4	29.5
RoW	8.0	7.8	8.0	8.5	8.0
<b><u>Growth QoQ (%) - Constant Currency</u></b>					
Americas	-0.1	1.3	-6.9	4.9	3.2
Europe	5.0	-0.1	-8.5	2.2	6.3
RoW	10.6	0.9	-5.1	9.0	-4.5

Source: Company, ICICI Direct Research

Revenue growth was led by Americas and Europe

### Exhibit 4: Industry wise break-up

	Q3FY20	Q4FY20	Q1FY21	Q2FY21	Q3FY21
<b><u>Revenue by verticals (%)</u></b>					
Financial Services	21.6	21.1	22.4	22.1	21.4
Manufacturing	20.9	20.7	18.1	17.7	18.1
Lifesciences & Healthcare	12.2	12.5	13.7	14.1	13.6
Public Services	10.9	11.1	11.0	10.7	10.4
Retail & CPG	10.3	10.2	10.0	10.4	10.5
Telecommunications, Media, Publishing & Entertainment	9.0	8.3	7.6	7.7	8.3
Technology & Services	15.1	16.2	17.2	17.3	17.8
<b><u>Growth QoQ (%) - Constant currency</u></b>					
Financial Services	-2.1	-1.1	-1.7	2.6	-0.4
Manufacturing	7.9	-0.2	-18.8	1.5	5.6
Lifesciences & Healthcare	-3.6	2.3	1.9	8.6	0.0
Public Services	1.6	2.9	-7.1	0.2	0.5
Retail & CPG	4.5	0.3	-9.0	8.4	3.7
Telecommunications, Media, Publishing & Entertainment	9.7	-6.6	-15.5	6.1	12.1
Technology & Services	0.4	7.2	-1.2	6.3	6.8

Source: Company, ICICI Direct Research

Technology, retail, life-science, Manufacturing and telecommunications, media, publishing & entertainment led growth in quarter

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

	% contribution to revenues Q3FY21	% contribution to revenues Q2FY21	CC Growth QoQ (%)	CC Growth YoY (%)
<b><u>Revenue by verticals (%)</u></b>				
IT and Business Services	70.4	70.8	2.7	1.1
Engineering and R&D Services	15.5	15.7	2.5	-5.1
Products & Platforms	14.1	13.5	8.3	9.3

Source: Company, ICICI Direct Research

On QoQ basis, revenue growth driven by Products & Platforms

### Exhibit 6: Client & human resource matrix

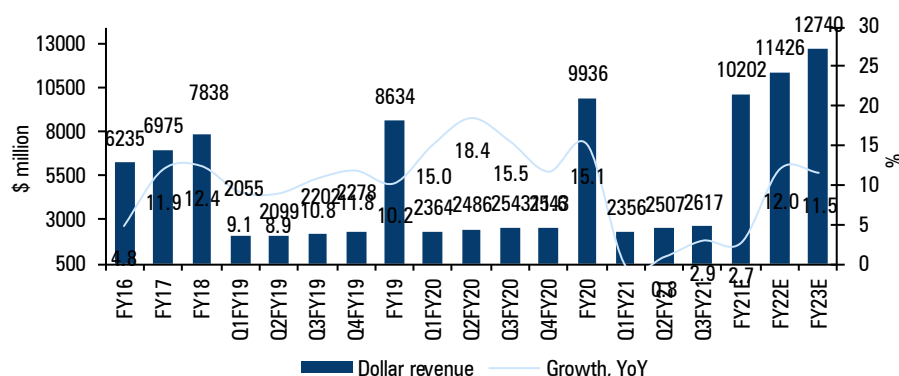
	Q3FY20	Q4FY20	Q1FY21	Q2FY21	Q3FY21
<b><u>Client metrics</u></b>					
US\$1-5 million	410	483	528	548	502
US\$10-20 million	73	75	80	81	76
US\$50-100 million	17	15	14	15	16
US\$100 million+	15	15	15	14	15
<b><u>Headcount, Utilization &amp; Attrition</u></b>					
Total Employees	1,49,173	1,50,423	1,50,287	1,53,085	1,59,682
Attrition - IT Services (LTM)	16.8	16.3	14.6	12.2	10.2

Source: Company, ICICI Direct Research

*Attrition declined in quarter. The company's number of employees increased by 6597*

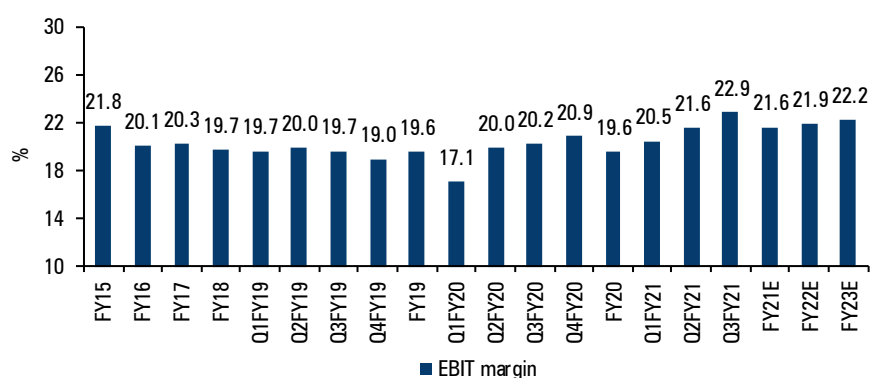
## Financial story in charts

**Exhibit 7: Dollar revenues to increase at CAGR of 8.6% over FY20-23E**



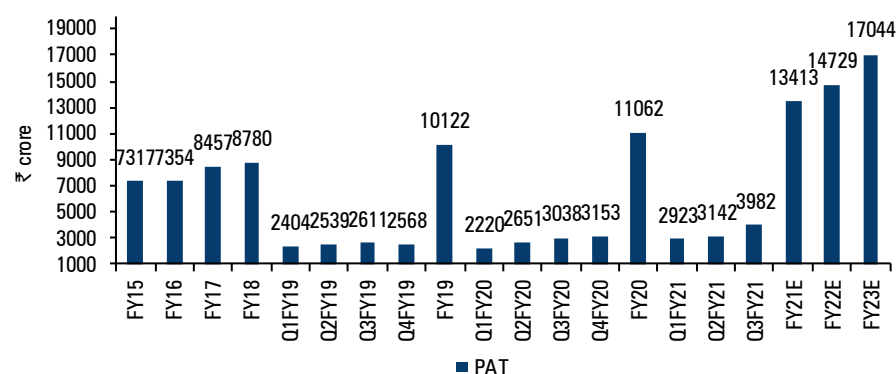
Source: Company, ICICI Direct Research

**Exhibit 8: Revise our margin estimates for FY21E, FY22E & FY23E**



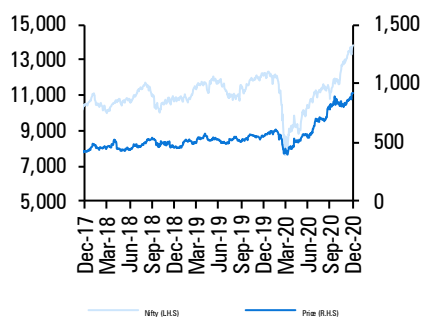
Source: Company, ICICI Direct Research

**Exhibit 9: PAT trend**



Source: Company, ICICI Direct Research

**Exhibit 10: Three Year Price Chart**



Source: Company, ICICI Direct Research

## Financial summary

Exhibit 11: Profit and loss statement ₹ crore				
	FY20	FY21E	FY22E	FY23E
<b>Total operating Income</b>	<b>70,678</b>	<b>75,758</b>	<b>84,552</b>	<b>95,549</b>
Growth (%)	17.0	7.2	11.6	13.0
Direct costs	45,295	46,591	51,830	58,476
S,G&A expenses	8,690	9,189	10,400	11,848
Total Operating Expenditure	53,985	55,780	62,230	70,324
<b>EBITDA</b>	<b>16,694</b>	<b>19,977</b>	<b>22,322</b>	<b>25,225</b>
Growth (%)	19.5	19.7	11.7	13.0
Depreciation	2,841	3,591	3,784	3,989
Amortisation	-	-	-	-
Net Other Income	178	380	591	900
PBT	14,031	16,766	19,128	22,136
Forex adjustments	-	-	-	-
Total Tax	2,938	3,353	4,399	5,091
<b>PAT</b>	<b>11,062</b>	<b>13,413</b>	<b>14,729</b>	<b>17,044</b>
Growth (%)	9.3	21.3	9.8	15.7
EPS (₹)	40.8	49.4	54.3	62.8
Growth (%)	9.2	21.3	9.8	15.7

Source: Company, ICICI Direct Research

Exhibit 12: Cash flow statement ₹ crore				
	FY20	FY21E	FY22E	FY23E
PBT	14,031	16,766	19,128	22,136
Depreciation & Amortisation	3,420	3,591	3,784	3,989
(Inc)/dec in Current Assets	(3,162)	(1,906)	(2,475)	(3,055)
Inc/(dec) in CL and Provisions	1,602	(5,408)	259	2,313
Taxes paid	(2,558)	(3,353)	(4,399)	(5,091)
<b>CF from operating activities</b>	<b>13,359</b>	<b>9,309</b>	<b>15,706</b>	<b>19,391</b>
(Inc)/dec in Investments	(4,452)	380	591	900
(Inc)/dec in Fixed Assets	(7,922)	(2,652)	(1,691)	(1,691)
<b>CF from investing activities</b>	<b>(12,374)</b>	<b>(2,272)</b>	<b>(1,100)</b>	<b>(791)</b>
Issue/(Buy back) of Equity	-	-	-	-
Inc/(dec) in loan funds	(246)	(1,250)	(1,000)	(1,000)
Dividend paid & dividend tax	(1,625)	(3,353)	(5,155)	(5,155)
Inc/(dec) in debentures	-	-	-	-
Others	(1,297)	-	-	-
<b>CF from financing activities</b>	<b>(3,168)</b>	<b>(4,603)</b>	<b>(6,155)</b>	<b>(6,155)</b>
Net Cash flow	(2,183)	2,434	8,450	12,445
Exchange difference	42	-	-	-
Opening Cash	5,934	4,976	7,410	15,861
Bank bal + unclaimed dvd.	-	-	-	-
<b>Cash &amp; bank c/f to balance sh</b>	<b>4,976</b>	<b>7,410</b>	<b>15,861</b>	<b>28,306</b>

Source: Company, ICICI Direct Research

Exhibit 13: Balance sheet ₹ crore				
	FY20	FY21E	FY22E	FY23E
<b>Liabilities</b>				
Equity Capital	543	543	543	543
Reserve and Surplus	50,724	60,784	70,357	82,247
Total Shareholders funds	51,267	61,327	70,900	82,790
Total Debt	4,693	3,443	2,443	1,443
Other liabilities + Provisions	4,907	4,982	5,113	5,276
Minority Interest / Others	154	154	154	154
<b>Total Liabilities</b>	<b>61,021</b>	<b>69,906</b>	<b>78,610</b>	<b>89,663</b>
<b>Assets</b>				
Net Block+ CWIP	8,542	9,578	9,566	9,462
Intangible assets+ Goodwill	29,348	27,373	25,292	23,098
Investments	77	77	77	77
Liquid investments	6,989	6,989	6,989	6,989
Inventory	91	98	109	123
Debtors	14,131	15,152	16,910	19,110
Loans and Advances	3,422	3,668	4,094	4,626
Other Current Assets	8,811	9,444	9,723	10,033
Cash	4,976	7,410	15,861	28,306
Total Current Assets	38,420	42,761	53,686	69,186
Total Current Liabilities	21,885	16,401	16,530	18,680
Net Current Assets	16,535	26,359	37,156	50,507
Other non current assets	6,519	6,519	6,519	6,519
<b>Application of Funds</b>	<b>61,021</b>	<b>69,906</b>	<b>78,610</b>	<b>89,663</b>

Source: Company, ICICI Direct Research

Exhibit 14: Key ratios ₹ crore				
	FY20	FY21E	FY22E	FY23E
<b>Per share data (₹)</b>				
EPS	40.8	49.4	54.3	62.8
Cash EPS	51.2	62.7	68.2	77.5
BV	189.0	226.0	261.3	305.1
DPS	9.5	12.4	19.0	25.1
Cash Per Share	18.3	27.3	58.5	104.3
<b>Operating Ratios (%)</b>				
EBIT Margin	19.6	21.6	21.9	22.2
PBT Margin	19.9	22.1	22.6	23.2
PAT Margin	15.7	17.7	17.4	17.8
Debtor days	73	73	73	73
<b>Return Ratios (%)</b>				
RoE	21.6	21.9	20.8	20.6
RoCE	23.0	24.0	24.3	24.7
RoIC	28.2	29.5	33.2	39.1
<b>Valuation Ratios (x)</b>				
P/E	24.3	20.0	18.2	15.7
EV / EBITDA	15.6	12.9	11.1	9.3
EV / Net Sales	3.7	3.4	2.9	2.5
Market Cap / Sales	3.8	3.5	3.2	2.8
Price to Book Value	5.2	4.4	3.8	3.2
<b>Solvency Ratios</b>				
Debt/EBITDA	0.3	0.2	0.1	0.1
Debt/EBITDA	0.3	0.2	0.1	0.1
Current Ratio	1.2	1.7	1.9	1.8
Quick Ratio	1.2	1.7	1.9	1.8

Source: Company, ICICI Direct Research



**Exhibit 15: ICICI Direct coverage universe (IT)**

Company	Cmp (₹)	TP (₹)	Rating	Mcap (₹ Cr)	EPS (₹)				P/E (x)				RoCE (%)				RoE (%)			
					FY20	FY21E	FY22E	FY23E	FY20	FY21E	FY22E	FY23E	FY20	FY21E	FY22E	FY23E	FY20	FY21E	FY22E	FY23E
HCL Tech (HCLTEC)	989	1,150	Buy	2,68,324	40.8	49.4	54.3	63	24	20	18	16	23.0	24.0	24.3	24.7	21.6	21.9	20.8	20.6
Infosys (INFTEC)	1,345	1,610	Buy	5,72,914	38.9	47.6	54.5	63	35	28	25	21	30.8	34.9	36.1	38.2	25.2	28.0	29.2	30.9
TCS (TCS)	3,233	3,600	Buy	12,13,127	86.2	89.0	107.7	124	38	36	30	26	43.5	44.0	46.9	49.2	37.5	35.7	39.3	40.9
Tech M (TECMAH)	1,007	1,105	Buy	97,424	45.9	50.0	58.8	69	22	20	17	15	19.1	18.7	19.8	20.9	18.5	18.3	18.9	19.5
Wipro (WIPRO)	438	490	Hold	2,56,579	16.6	19.8	21.8	24	26	22	20	18	19.3	22.4	24.6	27.2	17.4	19.9	22.0	24.5
Mindtree (MINCON)	1,696	1,680	Buy	27,953	38.3	58.8	68.0	76	44	29	25	22	23.0	29.7	30.0	29.6	20.0	25.5	25.4	24.6
LTI (LTINFEC)	4,278	3,850	Buy	74,746	86.6	105.9	126.5	149	49	40	34	29	30.7	31.8	31.6	31.3	28.1	28.3	28.3	28.0
Coforge (NIITEC)	2,638	2,690	Hold	15,880	71.4	75.7	94.4	110	37	35	28	24	23.0	25.5	27.0	27.6	18.5	20.1	22.0	22.6
Infoedge (INFEDG)	5,044	4,090	Buy	64,858	26.8	23.8	33.1	39	188	212	152	129	18.0	9.1	11.9	13.3	13.5	6.8	9.0	10.0
Teamlease (TEASER)	2,695	2,840	Buy	4,607	20.5	47.2	64.9	83	132	57	42	33	15.0	13.8	15.9	17.2	6.5	12.7	14.7	15.9

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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