Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

HCL Technologies

Q2 off-mark; eyeing bounce back in Q3

IT & ITES	Sharekhan code: HCLTECH	Result 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. 1,251**	
Price Target: **Rs. 1,400**	↔

↑ Upgrade ↔ Maintain ↓ Downgrade

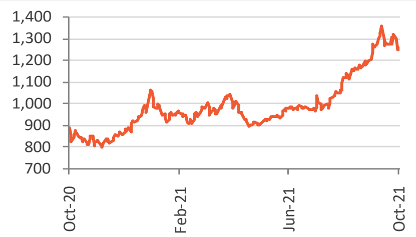
Company details

Market cap:	Rs. 339,452 cr
52-week high/low:	Rs. 1,377 / 800
NSE volume: (No of shares)	50.1 lakh
BSE code:	532281
NSE code:	HCLTECH
Free float: (No of shares)	107.6 cr

Shareholding (%)

Promoters	60.3
FII	23.8
DII	11.8
Others	4.1

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	1.0	20.3	26.2	40.5
Relative to Sensex	-4.2	5.0	0.6	-9.7

Sharekhan Research, Bloomberg

Summary

- Q2FY22 missed the mark due to a sharp fall in P&P business revenue; however, services revenue growth was strong, led by broad-based demand; Q2 saw healthy deal bookings, net employee additions and client addition
- As expected, the management reiterated its earlier guidance of a double-digit CC revenue growth and EBIT margins of 19-21%. The management guided for P&P revenue growth of 0-1% for FY2022 and expects a strong rebound in Q3.
- The company announced a policy that entails investor payouts of not less than 75% of net income cumulatively, over FY2022E to FY2026E, which is positive in our view.
- We maintain a Buy on HCL Technologies with a PT of Rs. 1,400, given strong deal wins, healthy client additions and reasonable valuations.

HCL Technologies' (HCL Tech's) Q2FY2022 headline numbers lagged our expectations despite strong recovery in services revenue, owing to sharp decline in P&P revenue. However, the company's order bookings (up 37% y-o-y), record net headcount additions, healthy client metrics and deal pipeline remained impressive. The company announced a policy that entails investor payouts of not less than 75% of the net income cumulatively over FY2022E to FY2026E, which is positive in our view as it is expected to address the concerns of investors relating to higher capital allocation towards inorganic initiatives. We believe that the company would return to good growth trajectory in the remaining quarters of FY2022 and in FY2023 as well on the back of its strength in both infrastructure and application business, solid positioning in ERS business, ramp-up of deals, strong deal pipeline and better growth outlook for product business.

Key positives

- Services business CC revenue grew 5.2% q-o-q and 13.1% y-o-y
- Strong deal TCVs, up 35% q-o-q and 37% y-o-y

Key negatives

- P&P business' CC revenue declined 8% q-o-q
- Attrition inched up by 390bps q-o-q to 15.7%

Management commentary

- Retained earlier guidance of double-digit revenue growth for FY2022E on CC terms
- Provided products and platforms (P&P) business revenue growth guidance of 0-1% versus low single digit earlier
- Maintained EBIT margin guidance of 19-21% for FY2022 versus 19.3% in H1FY2022

Revision in estimates - We slightly cut our earnings estimates for FY2022E, while maintained earnings estimate for FY2023E/FY2024E

Our Call

Valuation –Maintain Buy with a PT of Rs. 1,400: Strong deal pipeline, aggressive net employee additions, healthy deal bookings, a strong recovery in the P&P business and rising spends on digital and cloud initiatives provide strong revenue growth visibility in the medium term. Further, we believe the company's investments in sales, Mode-2 capabilities, new geography expansion and consistent in integrated deal wins would help to accelerate its growth in FY2023. Despite supply-side challenges, investments in geo-expansion and capability building and wage revision, we expect the company would sustain its margin performance on the back of revenue growth, employee pyramids, higher offshoring and expansion into smaller cities. We expect HCL Tech to report USD revenue and earnings growth at a CAGR of 10.2% and 10.4%, respectively over FY2021-FY2024E. At CMP, the stock trades at a reasonable valuation of 21x/19x its FY2023E/FY2024E earnings, a sharp discount to large peers including Wipro. Further, the company's recent dividend payout policy is positive as it is likely to abate investors' concerns relating to its capital allocation strategies. Hence, we maintain a Buy on the stock with an unchanged PT of Rs. 1,400.

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	FY21	FY22E	FY23E	FY24E
Revenue	75,379.0	85,155.2	95,205.9	1,04,811.7
OPM (%)	26.6	24.0	24.2	24.4
Adjusted PAT	13,010.0	13,357.7	15,429.4	17,487.8
% YoY growth	17.6	2.7	15.5	13.3
Adjusted EPS (Rs.)	47.9	50.7	58.5	66.3
P/E (x)	26.1	24.7	21.4	18.9
P/B (x)	5.7	5.4	5.0	4.7
EV/EBITDA (x)	16.3	16.3	14.6	13.3
RoNW (%)	23.3	21.7	23.6	25.1
RoCE (%)	25.0	24.0	26.8	28.7

Source: Company; Sharekhan estimates

Headline numbers miss the mark

HCL Tech's headline numbers lagged expectations in Q2FY2022 despite strong recovery in services revenue, owing to sharp decline in P&P revenue (accounted for 11.7% of total revenue). However, HCL Tech reported strong order bookings, robust net addition of employees and healthy client addition during the quarter. The company reported constant currency (CC) revenue growth of 3.5% q-o-q, below our estimates. Though services business' (accounted for 88.3% of total revenue) revenue growth bounced back strongly to 5.2% q-o-q on CC basis, P&P business revenue declined by 8% q-o-q on CC owing to deferral of licensing deals. Services business revenue growth was driven by 5.2%/13.2% q-o-q/y-o-y revenue growth in IT and business services and strong 5.4%/12.7% q-o-q/y-o-y revenue growth in engineering & R&D services (ERS). Mode-2 services delivered strong CC revenue growth of 12.5% q-o-q and 36.3% y-o-y because of traction in digital engineering and acceleration in application modernization and cloud transformation deals. USD revenues grew 2.6% q-o-q and 11.3% y-o-y to $2,791 million. EBIT margins declined by 63 bps q-o-q to 19.0%, below our estimates, owing to drop in product revenues, partial wage revision and currency headwinds. EBIT margin of IT and business services remained flat q-o-q, while EBIT margins of the ERS business and product business contracted 70 bps q-o-q and 430 bps q-o-q respectively. Net profit of Rs. 3,264 crore (up 1.6% q-o-q and 3.9% y-o-y) was below our estimates owing to miss in revenue and operating profitability. Cash conversion in terms of free cash flow (FCF) to net profit and FCF to EBITDA remained stable on q-o-q basis at 88% and 60%, respectively.

Q2FY2022 Key earnings call highlights

- **Product revenue remained a dampener:** HCL Tech' revenue growth performance missed our and street's estimates as well, attributed to sharp drop in product revenues. The company reported yet another quarter of lower-than-expected revenue growth despite 5.2% q-o-q/13.1% q-o-q growth in service revenues. IT and business service units reported strong growth (up 5.2% q-o-q/13.2% y-o-y on CC), led by acceleration in application modernization and cloud transformation deals. Similarly, the ERS business grew by 5.4% q-o-q and 12.7% y-o-y on a CC basis, driven by traction in digital engineering. Mode-1 and Mode-2 business reported revenue growth of 2.8% q-o-q and 12.5% q-o-q during Q2FY2022. However, products & platforms business declined 8% q-o-q and 5.5% y-o-y on a CC basis.

- **Commentary on products & platforms business:** P&P business continued to register a decline of 8% q-o-q in revenue, attributed to deferral of licensing deals and weak seasonality. Further, the management citied that a few deals were slipped to Q3FY2022. Hence, it expects a strong bounce back in revenue growth in Q3FY2022. During the quarter, the company had 280+ new footprint wins in this segment. Notably, the P&P growth in CC was at a 3.6% q-o-q. The management revised its earlier revenue growth guidance of low single digits for P&P business to 0-1% revenue growth for FY2022.

- **Maintained revenue and margin guidance for FY2022:** The management guided for double-digit CC revenue growth and EBIT margin of 19-21%, as expected. At the lower end of 10% revenue growth, the revenue CQGR stands at 1.6% for the remaining three quarters of FY2022E. The growth rate can be achieved comfortably by the company, given its strong deal wins and broad-based demand. Given sharp revenue decline in product and platform business, management guided revenue growth of 0-1% for its P&P business against low single-digit revenue growth guidance earlier. The management remains confident of delivering strong q-o-q growth for the rest of the year, given 42% y-o-y growth in deal bookings (cumulative order booking for last three quarters) and net hiring of over 27,500 employees. The company continues to see strong demand for all its services, especially digital business which include application services, digital consulting and data analytics and cloud services. Further, management indicated that the company continues to work closely with hyper scalers, OEMs and SaaS partners to offer the best-in-class integrated solutions for its clients. The management remains confident on revenue growth in the near-term on the back of strong order bookings, client additions, healthy pipeline, continued recovery in heavy assets segment and broad-based demand. Further, the company has built a market-leading momentum in technology modernisation and end-to-end digital transformation space across applications, engineering, infrastructure and BPO, which would help the company to drive its mid-term revenue growth.

- **Business segment performance:** (1) IT and business services revenue grew 5.2% q-o-q (up 13.2% y-o-y) in CC terms, led by higher spends in application modernisation, digital and cloud transformation initiatives. (2) Engineering and R&D services segment's revenue increased by 5.4% q-o-q in CC (up 12.7% y-o-y), led by higher spend on digital engineering. (3) P&P segment's revenue declined by 8% q-o-q (down 5.4% y-o-y) on CC terms, attributed to weak seasonality and slipping of revenues to Q3FY2022.
- **Vertical-wise performance:** The life sciences & healthcare, manufacturing, technology & services and telecommunication verticals led overall growth, with a rise of 7%, 8.1%, 2.6% and 3.0% q-o-q in CC terms, respectively.
- **Strong bounce back in growth in Europe:** America and Rest of World (RoW) reported revenue growth of 2.4% q-o-q (up 10.7% y-o-y) and 4% q-o-q (up 14.9% y-o-y) on a CC basis, while the Europe business recovered stronglyto 5.8% q-o-q (up9% y-o-y).
- **Commentary in ERS business:** The strong recovery in ERS business was led by a strong demand for Industry 4.0 solutions and the digital engineering services. The management stated that there has been strong recovery in asset heavy industries post pandemic. Further, hi-tech and telecom verticals started to spend on digital engineering, which would drive the growth of its ERS business.
- **Strong cash generation:** Free cash flow (FCF) stood at $390million (vs $403million in Q1FY22) with FCF to net income ratio at 88%. Net Cash stood at $2,171million versus $2,053million in Q1FY2022.
- **Healthy order bookings and order pipeline:** HCL Tech signed 14 large net new deals across the verticals, led by telecom, life sciences and healthcare, and manufacturing verticals. New deal TCVs remained at $2.25 billion, increasing 35% q-o-q and 37% y-o-y. Given its capabilities in both infrastructure and application business, the company is able to win integrated deals that improves its positioning in modern applications. The management cited that it sees good momentum in integrated deals in terms of both application and infrastructure modernisation programs. Management expects the resumption of industry-leading growth in digital foundation and infrastructure segment in coming quarters as it has won a good number of large deals in cloud migration, digital workplace and cyber security across geographies and verticals. During the quarter, out of 14 large deals, the company won 13 large services deal and one large product deals during the quarter.
- **Strong net headcount addition, attrition inched up:** Headcount increased by a net 11,135 on a sequential basis to 187,634. Net headcount addition remained highest ever in its history. Management indicated that the company hired 5,500 freshers during the quarter, taking total fresher hiring to 9000 during H1FY2022. The company recruited around 35,000 employees in last four consecutive quarters. Attrition rate stood at 15.7% in Q2FY2022 versus 11.8% in Q1FY2022. The management indicated that attrition rate would inch up in coming quarter considering a strong demand environment.
- **Strong client addition across all categories:** The number of $100 million clients grew by one each on both q-o-q and y-o-y to 15. Number of clients in $50 million and $20 million clients improved on sequential (up 4 and 5 respectively) and y-o-y (up 12 and 18 respectively) basis. The company also added 7 and 3 clients on a sequential basis in its $10 million and $5 million client category. This reflects a strong broad-based demand and relevant of its offering across all segments of its clients.
- **Pricing outlook:** The management highlighted that it has been collaborating with some existing clients to increase pricing given supply-side concerns. Further, the new deals have a slightly higher pricing structure. There are some green shoots of getting better rates, especially in its application business and engineering business.
- **Capital allocation:** HCL Tech announced an interim dividend of Rs.10 per share compared to Rs.6 per share in Q1FY22. HCL Tech announced a payout policy that entails investor payouts of not less than 75% of net income cumulatively over five years FY22E to FY26E. This is expected to address the concerns of investors relating to higher capital allocation towards inorganic initiatives.

Results Rs cr

Particulars	Q2FY22	Q2FY21	Q1FY22	y-o-y (%)	q-o-q (%)
Revenue ($ mn)	**2,790.7**	**2,506.6**	**2,719.6**	**11.3**	**2.6**
Net sales	**20,655.0**	**18,594.0**	**20,068.0**	**11.1**	**2.9**
Direct costs	12,758.0	10,929.0	12,197.0	16.7	4.6
Gross profit	**7,897.0**	**7,665.0**	**7,871.0**	**3.0**	**0.3**
Research & development	369.0	350.0	396.0	5.4	-6.8
SG&A	2,690.0	2,364.0	2,567.0	13.8	4.8
EBITDA	**4,838.0**	**4,951.0**	**4,908.0**	**-2.3**	**-1.4**
Depreciation andamortisation	922.0	935.0	977.0	-1.4	-5.6
EBIT	**3,916.0**	**4,016.0**	**3,931.0**	**-2.5**	**-0.4**
Forex gain/(loss)	79.0	-3.0	41.0	-	92.7
Other income	128.0	139.0	153.0	-7.9	-16.3
PBT	**4,123.0**	**4,152.0**	**4,125.0**	**-0.7**	**0.0**
Tax provision	846.0	999.0	894.0	-15.3	-5.4
Net profit	**3,264.0**	**3,142.0**	**3,214.0**	**3.9**	**1.6**
EPS (Rs.)	12.4	11.6	12.3	6.9	1.0
Margin (%)				**BPS**	**BPS**
EBITDA	23.4	26.6	24.5	-320	-103
EBIT	19.0	21.6	19.6	-264	-63
NPM	15.8	16.9	16.0	-110	-21
Tax rate	20.5	24.1	21.7	-354	-115

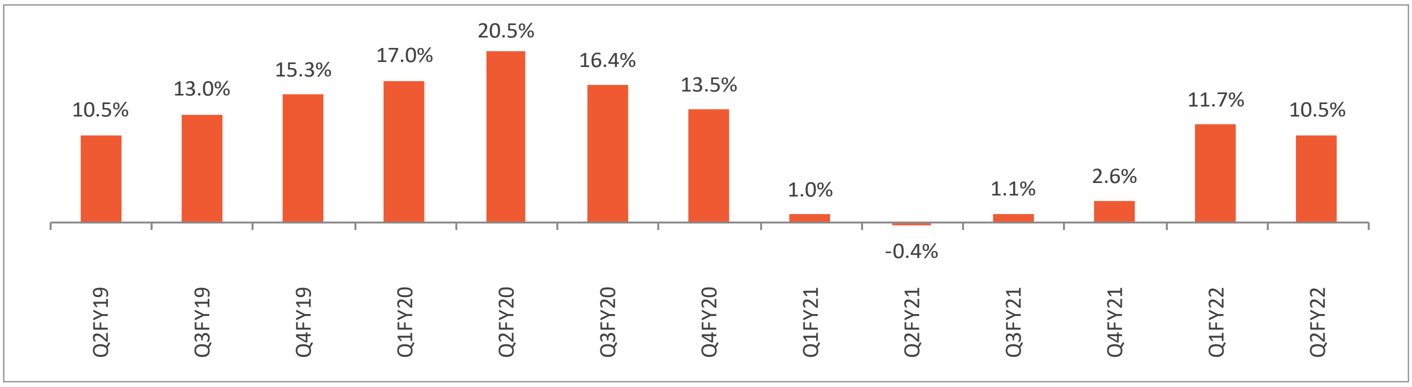
Source: Company; Sharekhan Research

Revenue mix: Geographies, industry verticals and other operating metrics

Particulars	Revenues ($ mn)	Contribution (%)	$ Growth (%)		CC growth (%)	
			q-o-q	y-o-y	q-o-q	y-o-y
Revenues ($ mn)	2,791	100	2.6	11.3	3.5	10.5
Geographic mix						
Americas	1,753	62.8	2.1	10.8	2.4	10.7
Europe	790	28.3	4.1	10.9	5.8	9.0
RoW	248	8.9	1.5	16.6	4.0	14.9
Industry verticals						
Financial services	594	21.3	-1.1	7.3	0.4	6.3
Manufacturing	500	17.9	6.8	12.6	8.1	11.9
Technology & services	480	17.2	2.0	10.7	2.6	10.8
Retail & CPG	273	9.8	0.6	4.9	0.9	3.6
Telecommunications, media, publishing & entertainment	220	7.9	2.6	14.2	3.0	13.4
Lifesciences & healthcare	427	15.3	6.8	20.8	7.0	20.1
Public services	296	10.6	0.7	10.3	1.9	8.8
Service line						
IT and business services	2,026	72.6	4.0	14.2	5.2	13.2
Engineering and R&D Services	438	15.7	5.3	11.3	5.4	12.7
Products & platforms	327	11.7	-8.4	-3.5	-8.0	-5.5
Clients Contribution						
Top 5	354	12.7	0.2	3.2	-	-
Top 10	578	20.7	2.1	10.3	-	-
Top 20	834	29.9	0.9	8.8	-	-

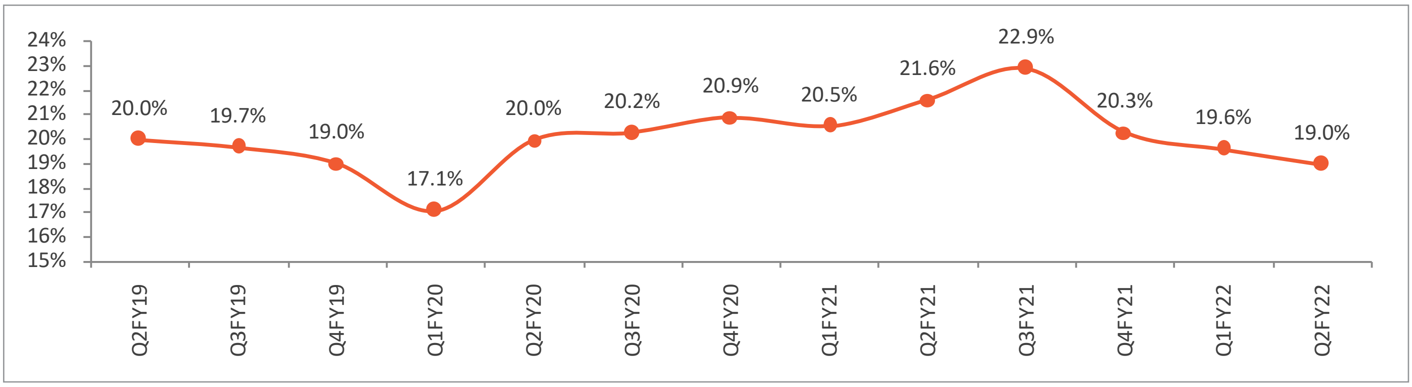
Source: Company; Sharekhan Research

HCL Tech' constant-currency revenue growth trend (y-o-y)



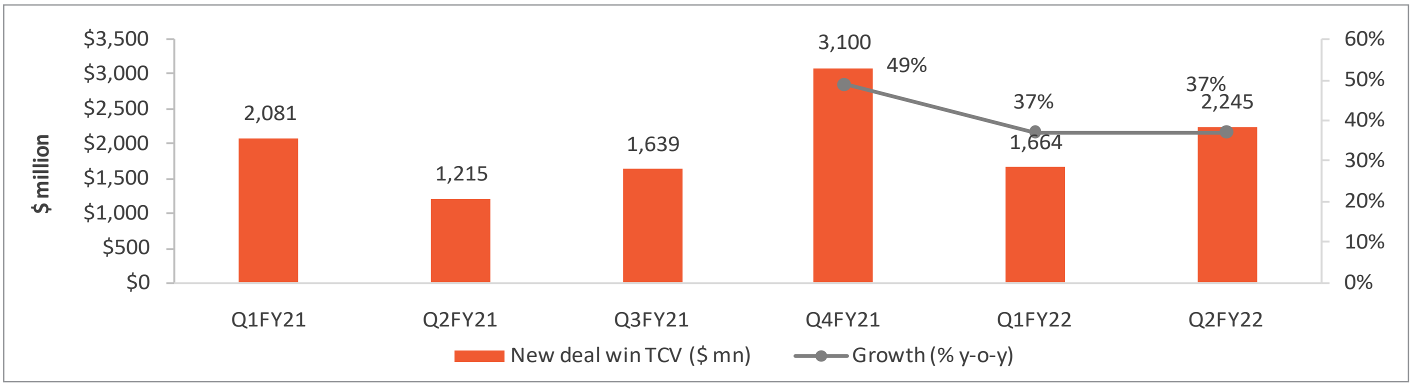
Source: Company, Sharekhan Research

EBIT margin contracted owing to decline in P&P's revenue



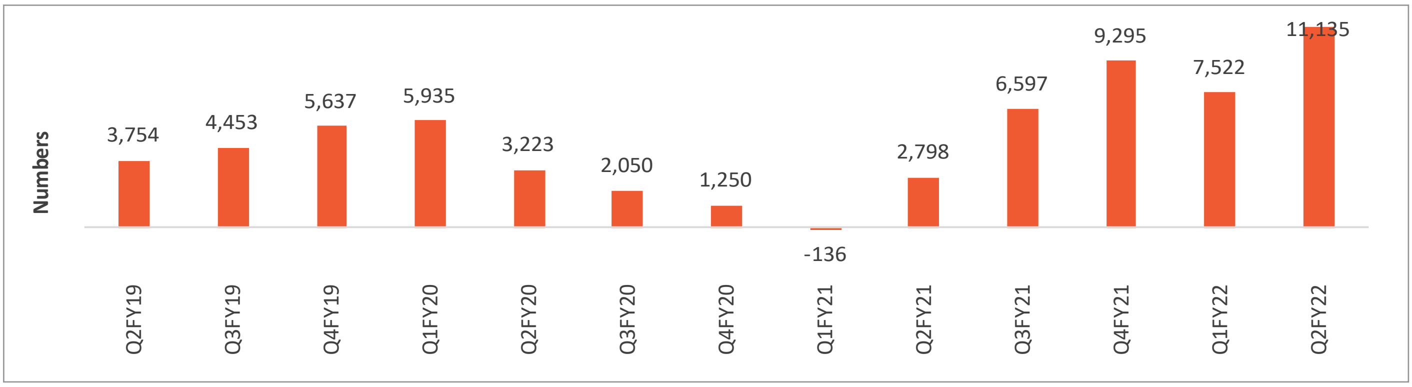
Source: Company, Sharekhan Research

New deal wins TCVs trend



Source: Company, Sharekhan Research

Strong net headcount addition



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector view - Expect acceleration in technology spending going forward

We believe that the need for business continuity, operational resilience and the switch to digital transactions has led to strong demand for IT services post pandemic. Industry analysts such as Gartner estimate that IT services spending would grow by 7-9% over CY2021-CY2024E as compared to the average of 3.6% achieved over CY2010-CY2020. Forecasts indicate higher demand for cloud infrastructure services, a potential increase in specialised software, potential investments in transformation projects by clients, and increased online adoption across verticals.

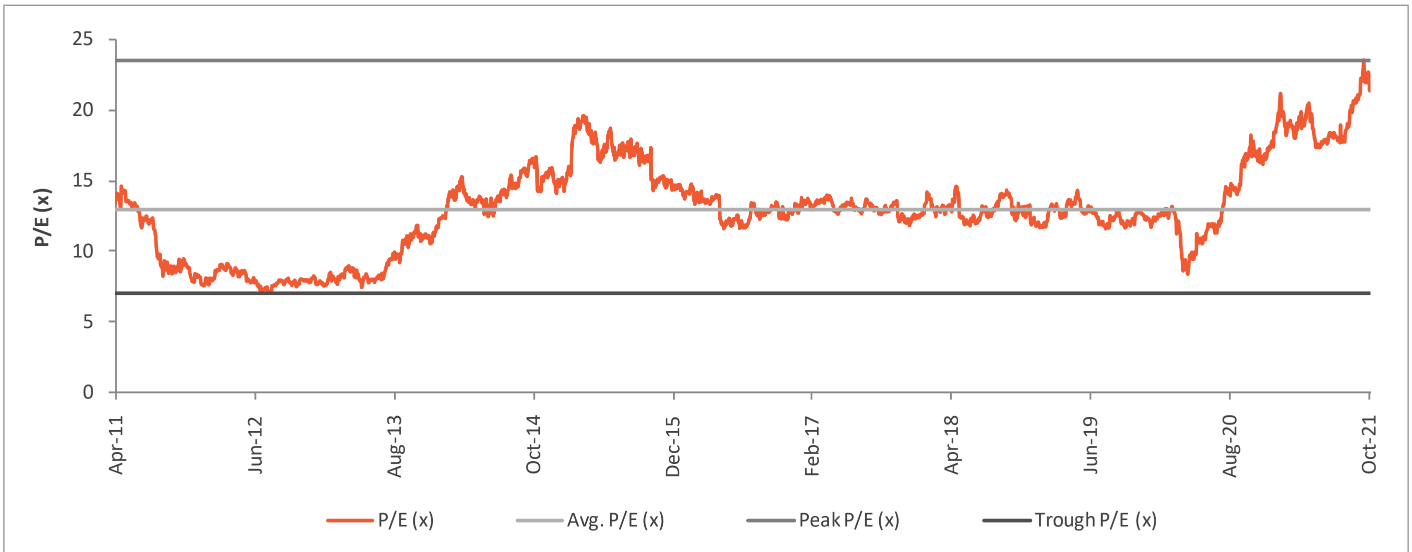
■ Company outlook - Growth on recovery path

HCL Technologies has invested aggressively in the fast-growing Mode-2 (a good proxy for digital offering) capabilities, which would help HCL Technologies to deliver a strong revenue growth in coming years. The company has made large investments towards the acquisition of IP products to diversify its focus on new high-margin revenue streams. 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. HCL Tech's strength in cloud infrastructure and capabilities in digital offerings, make it a strong contender for building out digital foundations for clients.

■ Valuation - Maintain Buy with an unchanged PT of Rs. 1,400

Strong deal pipeline, aggressive net employee additions, healthy deal bookings, a strong recovery in the P&P business and rising spends on digital and cloud initiatives provide strong revenue growth visibility in the medium term. Further, we believe the company's investments in sales, Mode-2 capabilities, new geography expansion and consistent in integrated deal wins would help to accelerate its growth in FY2023. Despite supply-side challenges, investments in geo-expansion and capability building and wage revision, we expect the company would sustain its margin performance on the back of revenue growth, employee pyramids, higher offshoring and expansion into smaller cities. We expect HCL Tech to report USD revenue and earnings growth at a CAGR of 10.2% and 10.4%, respectively over FY2021-FY2024E. At CMP, the stock trades at a reasonable valuation of 21x/19x its FY2023E/FY2024E earnings, a sharp discount to large peers including Wipro. Further, the company's recent dividend payout policy is positive as it is likely to abate investors' concerns relating to its capital allocation strategies. Hence, we maintain a Buy on the stock with an unchanged PT of Rs. 1,400.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer comparison

Company	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)		EV/EBIDTA (x)		P/BV (x)		RoE (%)	
				FY22E	FY23E	FY22E	FY23E	FY22E	FY23E	FY22E	FY23E
Infosys	1,716	424	7,27,692	32.3	27.3	22.2	19.3	4.8	4.5	27.6	30.2
TCS	3,611	370	13,35,838	34.1	29.7	24.2	21.1	15.0	14.6	44.5	49.9
Wipro	708	548	3,87,795	32.1	28.2	21.6	18.7	6.8	6.0	19.0	20.4
HCL Tech	1,251	271	3,39,452	24.7	21.4	16.3	14.6	5.4	5.0	21.7	23.6

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 – Engineeringand R&D Services
Rahul Singh	President – Financial Services

Source: Company

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	SBI Funds Management Pvt Ltd	2.17
2	Life Insurance Corp of India	1.94
3	Artisan Partners LP	1.79
4	BlackRock Inc	1.64
5	ICICI Prudential Asset Management	1.39
6	Vanguard Group Inc/The	1.30
7	Vontobel Holding AG	0.80
8	Virtus Investment Partners Inc	0.76
9	FMR LLC	0.72
10	Nomura Holdings Inc	0.71

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

Sharekhan

by BNP PARIBAS

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