

HCL Technologies

BSE Sensex
60,008

S&P CNX
17,899

HCL

Bloomberg	HCLT IN
Equity Shares (m)	2,714
M.Cap.(INRb)/(USDb)	3129.9 / 42.1
52-Week Range (INR)	1377 / 792
1, 6, 12 Rel. Per (%)	-6/4/5
12M Avg Val (INR M)	6188

Financials & Valuations (INR b)

Y/E Mar	2021	2022E	2023E
Sales	754	846	976
EBIT Margin (%)	20.4	19.4	20.0
PAT	119	133	155
EPS (INR)	43.8	49.1	57.2
EPS Gr. (%)	7.5	12.1	16.6
BV/Sh. (INR)	227	233	240

Ratios

RoE (%)	21.0	21.4	24.2
RoCE (%)	18.7	19.2	21.8
Payout (%)	59.4	75.0	75.0

Valuations

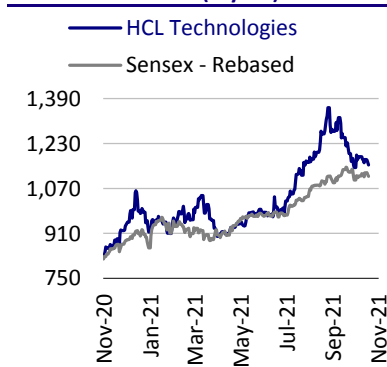
P/E (x)	26.3	23.5	20.1
P/BV (x)	5.1	5.0	4.8
EV/EBITDA (x)	16.1	15.2	12.9
Div Yield (%)	2.3	3.2	3.7

Shareholding pattern (%)

As On	Sep-21	Jun-21	Sep-20
Promoter	60.3	60.3	60.3
DII	12.5	11.4	10.7
FII	22.3	23.2	24.9
Others	4.9	5.1	4.1

FII Includes depository receipts

Stock Performance (1-year)


CMP: INR1,153
TP: INR1,430 (+24%)
Buy

Services strength to cushion any Product softness

Maintain Buy

- We expect the robust performance in HCL's Services business, especially the ER&D vertical, to continue as the demand environment remains favorable. We also draw comfort from improving management commentary on continued growth momentum in the IT Services business.
- Sustainable demand momentum for Cloud and Digital Engineering benefits HCLT, given its large presence within IMS and ER&D and continued investments in capabilities. Strong headcount additions and deal wins reflects the management's confidence on a sustainable growth momentum.
- We continue to see potential in HCLT's Products and Platforms business. While, the recent departure of the head of Products has elevated concerns on business recovery. However, we don't see a meaningful risk of a further hit from this event, our sensitivity analysis (*Exhibit 7*) suggests limited impact on EPS even in a bear case (4% decline in revenue for the Products and Platforms business in FY23E would lead to a 2.6% drag on our EPS estimate).
- On a combined basis, HCLT should deliver USD revenue growth of 13.1% over FY21-23E. We expect EBIT margin to stabilize at 20% in FY23E, which should help it deliver 14.3% PAT CAGR over FY21-23E.
- HCLT's recent revision in payout policy (at least 75% of net income, up from 50%) over FY22-26 is a positive. A higher payout reflects a strategic shift to focus on organic growth and limit inorganic investments to bolt-on and capability based acquisitions (v/s large revenue accretive acquisitions).
- We maintain our **Buy** rating as we expect traction in the Services business in 2HFY22E and FY23E, driven by higher IMS/Cloud-focused deals.

Services business – headcount addition illustrates strength

- There is a big divergence between revenue growth and employee addition at HCLT over the last four quarters (*Exhibit 1 and 2*), which stands out v/s its peers.
- We view the front ending of employee addition (~35k over the last four quarters, +22% YoY) as a smart move and a safeguard against the current supply crunch.
- It also points to the management's confidence in growth acceleration in the Services business over the next few quarters, which should help usher revenue growth and employee productivity back to its historical levels.
- Fresher hiring has seen an acceleration and is expected to rise further. HCLT hired 5.5k freshers in 2Q (v/s 3.5k in 1Q) and intends to hire 20k freshers in FY22.
- We expect HCLT to deliver USD revenue growth of 14.1% in Services over FY21-23E.

Beneficiary of Cloud transformation led by IMS leadership

- Cloud transformation is the backbone of the current acceleration in technological demand. As per Gartner, end-user spending on Cloud services is ~USD330b in CY21E, and is growing at more than 20% CAGR over CY20-23E (*Exhibit 8*). Moreover, IaaS will see the highest growth at 34% CAGR.
- HCLT's strong IMS capabilities (over 30% of revenue) and partnerships with leading hyperscalers, strategically positions it to capture the high growth opportunity in Cloud.
- It has been one of the early movers in the Cloud ecosystem and is one of the first large system integrators in the world to design dedicated business units for each Cloud hyperscaler, some as far back as two years ago.

Large engineering presence to benefit from demand momentum

- HCLT has one of the largest global ER&D practices. This includes client relationships with 65 of the top 100 global ER&D spenders.
- It has a balanced mix of asset heavy (Aero, Auto, Industrial, Telecom, etc.) and asset light verticals (Software and internet, Healthcare, etc.).
- The management has laid down an investment plan for new emerging technologies like Softwareization within Digital Engineering, IoT, 5G, etc. A significant part of this investment would focus on training its employees, besides enhancing its digital Centers of Excellence for deeper capability incubation. It currently has more than 80 engineering labs (v/s over 50 labs for LTTS).
- The demand momentum within ER&D is strong, with demand for full scale digital engineering solutions steadily increasing. Deal sizes and visibility for ER&D services has been increasing. Its large ER&D presence and capability enhancing investments will drive continued growth for this business.

Products and Platforms – a bumpy ride ahead

- HCLT's Products and Platforms business, which also houses software acquired from IBM, has been witnessing multiple challenges like: 1) discontinuation of certain products, 2) decline in 2QFY22 revenue led by end of quarter delays in deal signings, and 3) resignation of Mr. Darren Oberst, CEO, HCL Software.
- Leadership attrition in an already challenged business increases the risk to a sustainable recovery. The management's guidance and commentary for the P&P business has gradually become cautious (*Exhibit 6*). We have created a sensitivity analysis (*Exhibit 7*), which depicts that even in a bear case (4% decline in P&P revenue in FY23E), the EPS impact is restricted to 2.6%.

Higher shareholder payouts depict a strategic shift

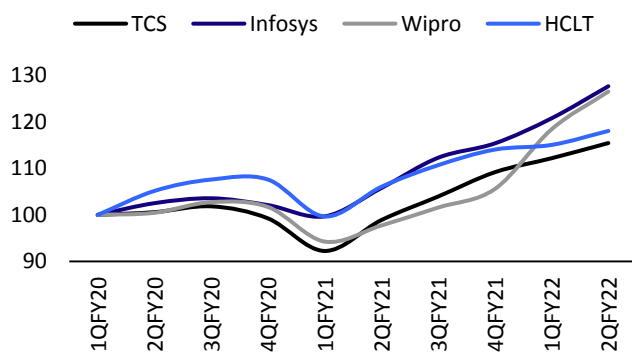
- HCLT's acquisition intensity in the past has led to lower shareholder payouts v/s larger peers.
- The company has been constantly improving its shareholder payouts. It has recently announced a dividend payout policy, which implies a distribution of at least 75% of net income over a five-year period.
- The management has revised its quarterly dividends to INR10/share (from INR6/share) for FY22. The quarterly DPS has been continuously moving up to INR10/share in 2QFY22 v/s INR1/share (adjusted for the stock split) in FY19.

- The 75% payout ratio would be the highest in the past 15 years. We see this commitment as a strategic shift to focus on organic growth and limit inorganic investments to bolt-on and capability-based acquisitions (v/s large revenue accretive acquisitions).

Valuations offer a safety margin

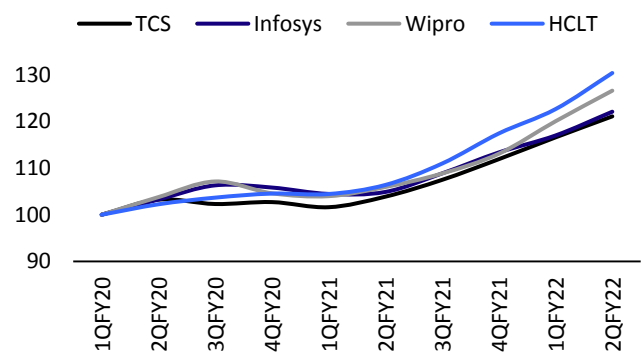
Given its deep capabilities in IMS and strategic partnerships, investments in Cloud, and Digital capabilities, we expect HCLT to emerge stronger on the back of an expected increase in enterprise demand for these services. The stock is currently trading ~20.1x FY23E EPS, which offers a margin of safety. Our TP is based on 25x FY23E EPS. We maintain our **Buy** rating.

Exhibit 1: HCLT's revenue growth has lagged peers...



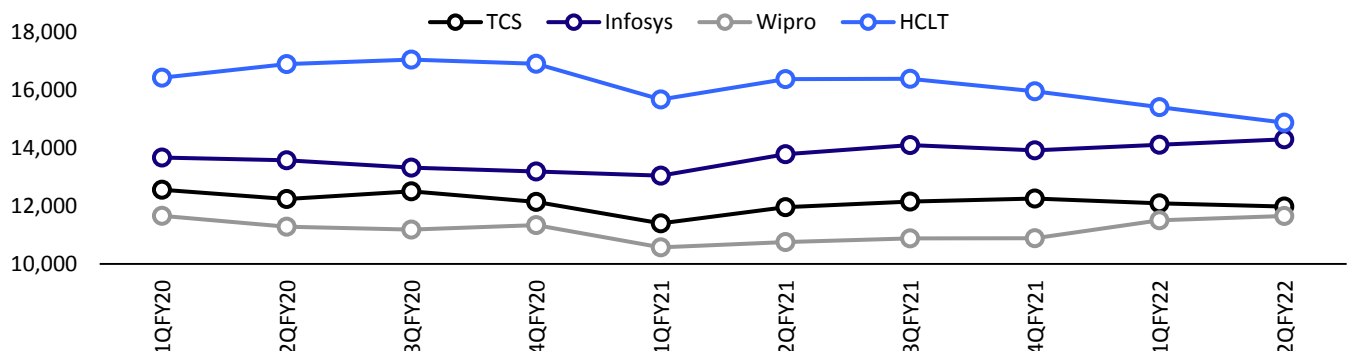
Source: Company, MOFSL

Exhibit 2: ...but employee additions remain strong



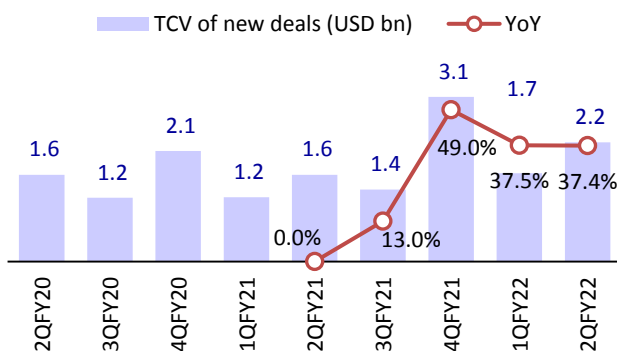
Source: Company, MOFSL

Exhibit 3: Expect divergence in employee productivity at HCLT to reverse over the next few quarters



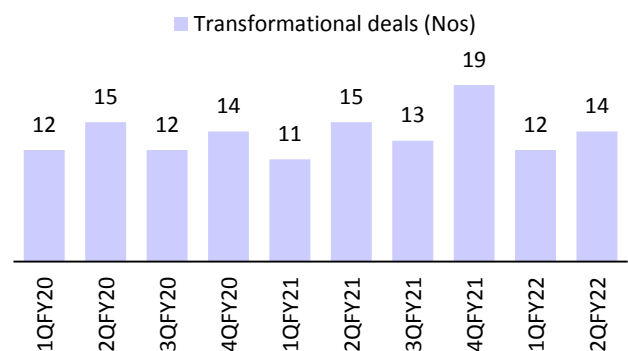
Source: Company, MOFSL

Exhibit 4: Strong momentum in deal wins...



Source: Company, MOFSL

Exhibit 5: ...and stable large deal wins



Source: Company, MOFSL

Exhibit 6: Trend in management commentary on the Products and Platforms business suggests increased caution

Products and Platforms Business	Management commentary and outlook
1QFY20	❖ Purchased select IBM products for USD2,163m, which got consummated on 1 st Jul'19. Products included AppScan, Digital Experience, Domino, and notes and Unica /Marketing software. The management was confident about a revenue run-rate of USD625m. ETR jumped to 24% due to this acquisition and had a 2.2% PBT impact
2QFY20	❖ The management expects Products and Platforms to be margin accretive. It highlighted that the Products business was seasonal under IBM's ownership. However, it expects seasonality to gradually abate under HCLT's ownership
3QFY20	❖ The company added close to 4,600 customers globally, including some geographies where the company was not present before. AppScan bagged 27 new customers in 3QFY20. BigFix had 23 new footprint wins
4QFY20	❖ Strong quarter, with incremental revenue of USD160m from acquired Products. The management guided at USD650m in FY21, with margin at over 30%. The company continued to invest on S&M for increased traction
1QFY21	❖ Pandemic driven challenges created new demand and use cases for some Products. HCLT saw new license growth in several areas like e-commerce, Digital Marketing, Digital Experience, and Security
2QFY21	❖ The management said certain Products in the portfolio will see good growth trajectory, while some would be stable
3QFY21	❖ The P&P business surpassed peak revenue in 4QFY20. HCLT also saw a 30% increase in cross-selling of Products and services. The management indicated a seasonally soft P&P business in 4QFY21
4QFY21	❖ The management said it is planning to launch 'HCL Now', which will be a SaaS version of all products. It guided at double-digit growth for 75% of Products, while the balance would decline in double-digits (higher decline in the near term, given the planned discontinuation of a couple of Products). It guided at low to mid-single digit growth in the Product business
1QFY22	❖ The performance of the P&P business was in line with the management's expectation. Guidance for the business has been kept at low single digits for FY22 and at mid-single digits on a sustainable basis
2QFY22	❖ Decline in the Products and Platforms business was led by an end of quarter delays in deal signings. The impact was from Products acquired from IBM and was led by one large and several small contracts. While none of these contracts have been closed yet, the management is confident of closing majority of them in 3QFY22. The management reduced its guidance for the P&P business to 0-1% YoY growth (v/s low single-digits earlier)

Source: Company, MOFSL

Exhibit 7: Sensitivity analysis of the impact of P&P business growth on consolidated revenue and EPS

Growth in P&P Business (YoY)	-4%	-2%	0%	2%	4%	6%	8%	10%
Change in consolidated FY23E Revenue	-1.5%	-1.3%	-1.1%	-0.8%	-0.6%	-0.4%	0.0%	0.4%
Change in consolidated FY23E EPS	-2.6%	-2.2%	-1.8%	-1.3%	-0.9%	-0.4%	0.0%	0.5%

Source: MOFSL estimates

Exhibit 8: HCLT to benefit from strong growth within the Cloud services space

Worldwide public Cloud services end-user spending forecast (USD m)	CY20	CY21	CY22	CAGR (CY20-22)
Cloud Business Process Services (BPaaS)	46,131	50,165	53,121	7%
Cloud Application Infrastructure Services (PaaS)	46,335	59,451	71,525	24%
Cloud Application Services (SaaS)	1,02,798	1,22,633	1,45,377	19%
Cloud Management and Security Services	14,323	16,029	18,006	12%
Cloud System Infrastructure Services (IaaS)	59,225	82,023	1,06,800	34%
Desktop as a Service (DaaS)	1,220	2,046	2,667	48%
Total market	2,70,033	3,32,349	3,97,496	21%

Note: Total may not add up due to rounding

BPaaS = Business Process as a Service; IaaS = Infrastructure as a Service; PaaS = Platform as a Service; SaaS = Software as a Service

Source: Gartner (Apr'21)

Exhibit 9: Tier 1 IT valuation table

Cos	Rating	Price	Mcap	Target	TP	Upside/	EPS			P/E (x)			PEG	CAGR FY21-23E, %	
		(INR)	(INR b)	(P/E FY23)	(INR)	downside	FY21	FY22E	FY23E	FY21	FY22E	FY23E	FY21-23E	USD revenue	EPS
TCS	Neutral	3,524	13,035	31	3,770	7%	86.7	105.4	121.6	40.6	33.4	29.0	1.8	13.3	15.2
INFO	Buy	1,788	7,520	30	1,960	10%	45.5	52.8	65.3	39.3	33.8	27.4	1.7	15.9	14.9
WPRO	Neutral	661	3,625	28	710	7%	18.8	22.2	25.4	35.3	29.8	26.1	1.6	17.5	14.6
HCLT	Buy	1,153	3,130	25	1,430	24%	43.8	49.1	57.2	26.3	23.5	20.1	1.4	12.4	13.0
TECHM	Neutral	1,618	1,570	22	1,640	-8%	51.7	64.6	74.7	31.3	25.0	21.7	1.3	14.2	15.7

Source: Company, MOFSL

Financials and valuations

Income Statement							(INR b)	
Y/E March	FY16	FY17	FY18	FY19	FY20	FY21	FY22E	FY23E
Sales	409	467	506	604	707	754	846	976
Change (%)	14.6	14.2	8.2	19.5	17.0	6.7	12.2	15.3
Cost of Goods Sold	268	309	332	393	453	467	533	610
Gross Profit	141	158	173	212	254	287	313	366
Selling and Admin. Exp.	52	55	59	72	87	93	109	125
EBITDA	89	103	114	140	167	193	205	241
As a percentage of Net Sales	21.8	22.1	22.6	23.1	23.6	25.6	24.2	24.7
Depreciation	6	8	15	21	28	40	40	46
EBIT	83	95	100	118	139	153	164	195
As a percentage of Net Sales	20.4	20.3	19.8	19.6	19.6	20.4	19.4	20.0
Other Income	10	9	11	8	2	7	8	10
PBT	94	104	111	126	140	160	173	205
Tax	19	23	23	25	29	41	39	49
Rate (%)	20.4	21.7	20.9	19.6	20.9	25.4	22.6	24.0
PAT	74	82	88	101	111	119	134	156
Net Income	74	85	88	101	111	119	133	155
Change (%)	1.9	13.5	3.8	15.3	9.3	7.4	12.1	16.6

Balance Sheet							(INR b)	
Y/E March	FY16	FY17	FY18	FY19	FY20	FY21	FY22E	FY23E
Reserves	280	335	368	422	517	615	631	650
Net Worth	280	335	368	422	517	615	631	650
Loans	10	5	4	40	51	39	39	39
Other liabilities	13	13	13	15	55	55	60	68
Capital Employed	303	353	385	477	623	709	731	757
Gross Block	163	225	274	335	511	546	580	619
Less: Depreciation	55	64	78	100	128	168	208	254
Net Block	107	161	196	235	383	378	372	365
Other assets	40	39	40	57	65	69	74	83
Investments	111	114	83	55	105	140	140	140
Curr. Assets	139	151	165	243	279	291	320	357
Debtors	107	108	123	146	178	175	207	236
Cash and Bank Balance	7	13	17	59	38	65	57	56
Other Current Assets	24	30	25	37	64	50	57	65
Current Liab. and Prov.	95	111	99	111	209	168	175	188
Net Current Assets	44	40	66	131	70	123	145	170
Application of Funds	303	353	385	477	623	709	731	757

Financials and valuations

Ratios

Y/E March	FY16	FY17	FY18	FY19	FY20	FY21	FY22E	FY23E
Diluted (INR)								
EPS	52.8	28.9	31.3	36.8	40.7	43.8	49.1	57.2
Cash EPS	56.8	32.9	36.4	44.6	51.2	58.5	63.8	74.1
Book Value	199.4	118.6	131.4	153.5	190.4	226.7	232.7	239.7
DPS	22.0	12.0	6.0	4.0	8.0	26.0	36.8	42.9
Payout (%)	41.7	41.6	23.1	50.4	19.6	59.4	75.0	75.0
Valuation (x)								
P/E	21.8	40.0	36.9	31.4	28.3	26.3	23.5	20.1
Cash P/E	20.3	35.1	31.6	25.9	22.5	19.7	18.1	15.6
EV/EBITDA	18.2	31.5	28.1	22.6	18.8	16.1	15.2	12.9
EV/Sales	4.0	6.9	6.4	5.2	4.4	4.1	3.7	3.2
Price/Book Value	5.8	9.7	8.8	7.5	6.1	5.1	5.0	4.8
Dividend Yield (%)	1.9	1.0	0.5	0.3	0.7	2.3	3.2	3.7
Profitability Ratios (%)								
RoE	28.2	26.5	25.0	25.6	23.6	21.0	21.4	24.2
RoCE	24.5	23.6	22.2	22.8	21.3	18.7	19.2	21.8
Turnover Ratios								
Debtors (Days)	96	84	88	88	92	85	89	88
Asset Turnover (x)	3.8	2.9	2.6	2.6	1.8	2.0	2.3	2.7

Cash Flow Statement

Y/E March	FY16	FY17	FY18	FY19	FY20	FY21	FY22E	FY23E
(INR b)								
CF from Operations	80	90	102	123	149	166	209	201
Change in Working Capital	-8	5	-35	-34	-16	30	-30	-27
Net Operating CF	72	95	68	88	134	196	179	174
Net Purchase of FA	-11	-62	-49	-61	-18	-18	-34	-39
Net Purchase of Invest.	-7	-2	30	29	-105	-40	0	0
Net Cash from Inv.	-18	-64	-19	-32	-124	-57	-34	-39
Issue of shares/other adj.	0	0	0	0	0	0	0	0
Proceeds from LTB/STB	5	9	-1	35	-15	-79	0	0
Dividend Payments	-31	-34	-20	-51	-16	-33	-117	-136
Net CF from Finan.	-26	-25	-21	-16	-32	-112	-117	-136
Free Cash Flow	61	33	18	28	115	179	145	135
Net Cash Flow	29	6	27	41	-22	27	28	-1
Forex difference	-35	0	-27	5	0	1	-37	0
Opening Cash Balance	13	7	13	13	60	38	66	57
Closing Cash Balance	7	13	13	60	38	66	57	55

NOTES

Explanation of Investment Rating	
Investment Rating	Expected return (over 12-month)
BUY	>=15%
SELL	< - 10%
NEUTRAL	< - 10 % to 15%
UNDER REVIEW	Rating may undergo a change
NOT RATED	We have forward looking estimates for the stock but we refrain from assigning recommendation

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