

Margin pressure on services to continue

About the stock: HCL Technologies (HCLT) offers IT, ER&D and products to BFSI, retail, health, telecommunication, manufacturing, media & hi-tech verticals.

- HCL Tech has 250 Fortune 500 and 650 global 2000 clients
- It has grown organically and inorganically (14% CAGR over FY18-21)

Q3FY22 Results: HCLT reported weak numbers on the margins front.

- Revenue increased 7.6% QoQ in CC terms. IT services, ER&D revenues grew 4.7%, 8.0%+, respectively, QoQ in CC terms
- EBIT margin of services business dipped 190 bps QoQ
- The company is looking to hire 20,000 freshers in FY22

What should investors do? HCLT's share price has grown by ~3.5x over the past five years (from ~₹ 382 in January 2017 to ~₹ 1,330 levels in January 2022).

- We downgrade the stock from BUY to HOLD rating

Target Price and Valuation: We value HCLT at ₹ 1430 i.e. 24x P/E on FY24E EPS

Key triggers for future price performance:

- The company continues to win multiyear deals in Cloud transformation, cyber security, etc as new deal bookings continue to be strong
- Expects healthy double digit growth in revenues in FY22E mainly led by improved growth in IT & business services and ER&D
- However, margins are expected to be under pressure for a few more quarters. We expect ~140 bps EBIT margin decline over FY21-24E
- With improvement in large deal wins, expansion in geographies, investment in sales & capabilities, we expect HCLT to register 12.7% CAGR in FY21-24E

Alternate Stock Idea: Apart from HCLT, in our IT coverage we also like TechM.

- Key beneficiary of uptick communication spend
- BUY with target price of ₹ 2,150

HCL

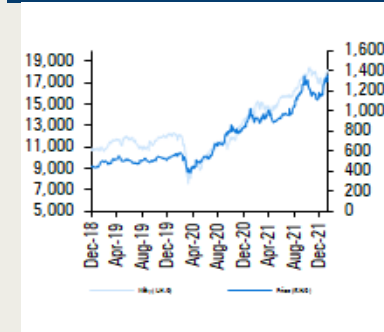
Particulars

Particular	Amount
Market Cap (₹ Crore)	362,274.3
Total Debt (₹ Crore)	3,828.0
Cash & Equivalent (₹ Crore)	15,661.0
EV (₹ Crore)	350,441.3
52 week H/L	1377 / 890
Equity capital	543.0
Face value	₹ 2

Shareholding pattern

	Dec-20	Mar-21	Jun-21	Sep-21
Promoters	60.3	60.3	60.3	60.3
FII	24.9	24.1	23.2	22.3
DII	10.3	10.5	11.0	12.2
Public	4.5	5.0	5.5	5.2

Price Chart



Recent Event & Key risks

- Margin for services (IT+ER&D) business dip 190bps QoQ
- Key Risk:** (i) Muted digital demand prospects, (ii) Better than expected margin performance

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Key Financial Summary

Key Financials	FY19	FY20	FY21	5 year CAGR (FY16-21)	FY22E	FY23E	FY24E	3 year CAGR FY(21-24E)
Net Sales	60,427	70,678	75,379	13.0%	86,841	98,119	107,931	12.7%
EBITDA	13,968	16,694	19,482	17.2%	20,451	22,764	24,932	8.6%
Margins (%)	23.1	23.6	25.8		23.6	23.2	23.1	
Net Profit	10,122	11,062	12,435	11.1%	13,022	14,893	16,166	9.1%
EPS (₹)	37.3	40.8	45.8		48.0	54.9	59.6	
P/E	35.8	32.7	29.1		27.8	24.3	22.4	
RoNW (%)	24.5	21.6	20.8		19.5	21.1	21.9	
RoCE (%)	26.9	23.0	23.5		23.0	25.1	26.2	

Source: Company, ICICI Direct Research

Key takeaways of recent quarter & conference call highlights

- Revenues at the company level in constant currency (CC) grew 7.6% QoQ while US\$ revenues increased 6.7% QoQ to \$2,978 million. Revenues in rupees have risen 8.1% QoQ to ₹ 22,331 crore. Business wise, IT services, ER&D, P&P grew 4.7%, 8.3%, 24.5%, respectively, QoQ in CC terms
- Revenues growth was aided by financial services, manufacturing, technology services, which grew 6.3%, 5.7%, 14%, respectively, QoQ in CC terms. In terms of Geographies, it was broad based across geographies where Europe, Americas, RoW grew 9.1%, 7.3%, 4.5%, respectively, QoQ in CC terms
- The company reported flattish EBIT margins of 19% at the company level while margins for services (IT services+ ER&D) were down 190 bps QoQ due to i) 80 bps impact of salary hike, ii) -65 bps due to loss of days due to furlough, iii) -85 bps on retention and bonus related, iv) -40bps new customer investment, which was mitigated by +60 bps operating efficiencies and +20 bps currency tailwind
- The management reiterated double digit revenue guidance for FY22 and 19-21% EBIT margin for FY22. The company indicated that 65 bps margin impact for the quarter (due to seasonal leaves) would not be recurring in nature but other factors may continue to impact for few quarters. Due to this, HCLT expects EBIT margins to be at the lower end of the guided range
- The company announced interim dividend of ₹ 10 per share, which is in line with their announcement in the last quarter to increase it from ₹ 7 per share to ₹ 10 per share
- The company's deal wins continue to be strong. It reported new deal wins at US\$2,145 million (mn), which was up 64% YoY. The company continues to win large deals in cloud, digital, cybersecurity. Also some of the verticals like Retail CPG, Manufacturing saw deal wins in the quarter
- The company continued to hire freshers to cater to the increasing demand. It added 5,000 freshers in Q3 over and above 5,500 freshers in Q2 and 3,500 in Q1. The company has guided for 20,000 fresher hiring for FY22E, which implies another 4000-5000 fresher addition in Q4Y22. HCLT indicated that they are looking to double fresher's hiring in FY23 vs. FY22. The company it is also looking to hire 2000 employees in US market in the next two to three years
- HCL is acquiring 100% stake in Starschema, a limited liability company incorporated in Hungary for total cash consideration of US\$42.5 mn. With this acquisition, HCL would enhance its capabilities and solutions in data engineering. The transaction is expected to be closed by March 2022. HCL Tech also announced the its acquisition of 51% stake in GBS has been completed now and it is effective from January 5, 2022
- HCLT saw an addition of 10,143 employees in Q2FY22, taking its overall full-time employee headcount to 1,97,777
- The company indicated that they are pushing for better pricing and some of the new/niche deals are coming with a better pricing. However, they maintained that pricing increase would be gradual in nature

Exhibit 1: Variance Analysis

	Q3FY22	Q3FY22E	Q3FY21	YoY (%)	Q2FY22	QoQ (%)	Comments
Revenue	22,331	21,529	19,302	15.7	20,655	8.1	Revenue was up 3.5% QoQ, led by IT services and ER&D grew by 5%+ while P&P declined 8% QoQ
Cost of sales (including employee expenses)	14,309	13,607	11,551	23.9	13,127	9.0	
Gross Margin	8,022	7,923	7,751	3.5	7,528	6.6	
Gross margin (%)	35.9	36.8	40.2	-423 bps	36.4	-52 bps	
Selling & marketing costs	2,780	2,799	2,309	20.4	2,690	3.3	
EBITDA	5,242	5,124	5,443	-3.7	4,838	8.4	
EBITDA Margin (%)	23.5	23.8	28.2	-472 bps	23.4	5 bps	
Depreciation	991	990	1,027	-3.5	922	7.5	
EBIT	4,251	4,134	4,416	-3.7	3,916	8.6	
EBIT Margin (%)	19.0	19.2	22.9	-384 bps	19.0	8 bps	EBIT margin at the company level was flat QoQ while that of services business declined 190 bps QoQ - 80 bps impact of salary hike, -65 bps due to loss of days due to furlough, -85 bps on retention and bonus related, -40 bps new customer investment. It was mitigated by +60 bps operating efficiency and +20 bps currency tailwind
Other income	203	190	126	NA	207	-1.9	
PBT	4,454	4,324	4,542	-1.9	4,123	8.0	
Tax paid	997	951	544	83.3	846	17.8	PAT higher due to higher other income
PAT	3,443	3,362	3,982	-13.5	3,264	5.5	

Source: Company, ICICI Direct Research

Exhibit 2: Change in estimates

	FY22E			FY23E			FY24E	Comments
(₹ Crore)	Old	New	% Change	Old	New	% Change	Introduced	
Revenue	85,467	86,841	1.6	96,567	98,119	1.6	107,931	We expect 12.7% CAGR revenue growth over FY21-24E
EBIT	17,563	16,617	-5.4	20,905	18,724	-10.4	20,687	
EBIT Margin (%)	20.5	19.1	-141 bps	21.6	19.1	-257 bps	19.2	We trim down margin due to costs pressures in the near term, as indicated by management amid supply side challenges
PAT	13,736	13,022	-5.2	16,540	14,893	-10.0	16,166	
EPS (₹)	51	48	-5.2	61	55	-10.0	60	

Source: Company, ICICI Direct Research

Key Metrics

Exhibit 3: Geography wise break-up

	Q3FY21	Q4FY21	Q1FY22	Q2FY22	Q3FY22
<u>Revenue by geography (%)</u>					
Americas	62.5	62.0	63.1	62.8	63.1
Europe	29.5	29.1	27.9	28.3	28.3
RoW	8.0	8.9	9.0	8.9	8.7
<u>Growth QoQ (%) - Constant Currency</u>					
Americas	3.2	2.0	2.6	2.4	7.3
Europe	6.3	0.7	-3.9	5.8	9.1
RoW	-4.5	13.3	2.4	4.0	4.5

Source: Company, ICICI Direct Research

Revenue growth was broad based across geographies

Exhibit 4: Industry wise break-up

	Q3FY21	Q4FY21	Q1FY22	Q2FY22	Q3FY22
<u>Revenue by verticals (%)</u>					
Financial Services	21.4	21.6	22.1	21.3	21.1
Manufacturing	18.1	17.7	17.2	17.9	17.5
Lifesciences & Healthcare	13.6	14.1	14.7	15.3	14.4
Public Services	10.4	11.2	10.8	10.6	10.4
Retail & CPG	10.5	10.1	10.0	9.8	10.1
Telecommunications, Media, Publishing & Entertainment	8.3	8.1	7.9	7.9	8.1
Technology & Services	17.8	17.2	17.3	17.2	18.4
<u>Growth QoQ (%) - Constant currency</u>					
Financial Services	-0.4	3.3	2.9	0.4	6.3
Manufacturing	5.6	0.3	-2.2	8.1	5.7
Lifesciences & Healthcare	0.0	6.6	5.4	7.0	0.9
Public Services	0.5	9.9	-3.4	1.9	6.1
Retail & CPG	3.7	-0.9	-0.1	0.9	11.5
Telecommunications, Media, Publishing & Entertainment	12.1	-0.1	-1.9	3.0	11.3
Technology & Services	6.8	-0.6	1.6	2.6	14.0

Source: Company, ICICI Direct Research

Financial services, Manufacturing, drove growth for the quarter

Exhibit 5: Segment offering wise break-up

	% contribution to revenues Q3FY22	% contribution to revenues Q2FY22	CC Growth QoQ (%)	CC Growth YoY (%)
<u>Revenue by verticals (%)</u>				
IT and Business Services	70.6	72.6	4.7	15.3
Engineering and R&D Services	15.9	15.7	8.3	19.7
Products & Platforms	13.5	11.7	24.5	8.2

Source: Company, ICICI Direct Research

On QoQ basis, revenue growth was driven by IT Services and Engineering & R&D services, while there was rebound in P&P business which was weak for last quarter

Exhibit 6: Client & human resource matrix

	Q3FY21	Q4FY21	Q1FY22	Q2FY22	Q3FY22
<u>Client metrics</u>					
US\$1-5 million	502	491	491	507	518
US\$10-20 million	76	82	79	81	88
US\$50-100 million	16	20	23	26	27
US\$100 million+	15	15	14	15	15
<u>Headcount, Utilization & Attrition</u>					
Total Employees	159,682	168,977	176,499	187,634	197,777
Attrition - IT Services (LTM)	10.2	9.9	11.8	15.7	19.8

Source: Company, ICICI Direct Research

Attrition increased 420 bps to 19.8% as witnessed for other IT players

Financial summary

Exhibit 7: Profit and loss statement					₹ crore
	FY21	FY22E	FY23E	FY24E	
Total operating Income	75,379	86,841	98,119	107,931	
Growth (%)	6.7	15.2	13.0	10.0	
Direct costs	46,550	55,318	62,600	68,752	
S,G&A expenses	9,348	11,072	12,755	14,247	
Total Operating Expenditure	55,898	66,390	75,355	82,999	
EBITDA	19,482	20,451	22,764	24,932	
Growth (%)	16.7	5.0	11.3	9.5	
Depreciation	3,985	3,835	4,040	4,245	
Amortisation	-	-	-	-	
Net Other Income	657	705	1,076	724	
PBT	16,154	17,321	19,800	21,411	
Forex adjustments	-	-	-	-	
Total Tax	3,663	4,244	4,851	5,246	
PAT	12,435	13,022	14,893	16,166	
Growth (%)	12.4	4.7	14.4	8.5	
EPS (₹)	45.8	48.0	54.9	59.6	
Growth (%)	12.4	4.7	14.4	8.5	

Source: Company, ICICI Direct Research

Exhibit 8: Cash flow statement					₹ crore
	FY21	FY22E	FY23E	FY24E	
PBT	16,154	17,321	19,800	21,411	
Depreciation & Amortisation	4,611	3,835	4,040	4,245	
(Inc)/dec in Current Assets	1,049	(4,165)	(4,098)	(3,565)	
Inc/(dec) in CL and Provisions	1,992	2,846	2,800	2,436	
Taxes paid	(3,445)	(4,244)	(4,851)	(5,246)	
CF from operating activities	19,618	14,832	16,559	18,557	
(Inc)/dec in Investments	(2,762)	705	1,076	724	
(Inc)/dec in Fixed Assets	(1,753)	(1,737)	(1,737)	(1,737)	
CF from investing activities	(5,742)	(1,032)	(661)	(1,013)	
Issue/(Buy back) of Equity	-	-	-	-	
Inc/(dec) in loan funds	(251)	(500)	(500)	(500)	
Dividend paid & dividend tax	(3,256)	(6,172)	(11,170)	(12,932)	
Inc/(dec) in debentures	-	-	-	-	
Others	(1,155)	-	-	-	
CF from financing activities	(11,180)	(6,672)	(11,670)	(13,432)	
Net Cash flow	2,696	7,128	4,228	4,112	
Exchange difference	65	-	-	-	
Opening Cash	4,976	8,888	16,016	20,244	
Bank bal + unclaimed divd.	-	-	-	-	
Cash & bank c/f to balance sheet	8,888	16,016	20,244	24,356	

Source: Company, ICICI Direct Research

Exhibit 9: Balance sheet					₹ crore
	FY21	FY22E	FY23E	FY24E	
Liabilities					
Equity Capital	543	543	543	543	
Reserve and Surplus	59,370	66,219	69,943	73,176	
Total Shareholders funds	59,913	66,762	70,486	73,719	
Total Debt	3,828	3,328	2,828	2,328	
Other liabilities+Provisions	4,901	5,104	5,303	5,477	
Minority Interest / Others	169	169	169	169	
Total Liabilities	68,811	75,363	78,786	81,692	
Assets					
Net Block+ CWIP	8,364	8,375	8,294	8,121	
Intangible assets+ Goodwill	29,093	26,984	24,762	22,428	
Investments	89	89	89	89	
Liquid investments	6,773	6,773	6,773	6,773	
Inventory	94	108	122	135	
Debtors	13,663	15,741	17,785	19,563	
Loans and Advances	4,841	5,577	6,301	6,932	
Other Current Assets	8,792	10,129	11,444	12,589	
Cash	8,888	16,016	20,244	24,356	
Total Current Assets	43,051	54,344	62,670	70,347	
Total Current Liabilities	17,383	20,026	22,627	24,890	
Net Current Assets	25,668	34,318	40,043	45,457	
Other non current assets	5,597	5,597	5,597	5,597	
Application of Funds	68,811	75,363	78,786	81,692	

Source: Company, ICICI Direct Research

Exhibit 10: Key ratios					₹ crore
	FY21	FY22E	FY23E	FY24E	
Per share data (₹)					
EPS	45.8	48.0	54.9	59.6	
Cash EPS	60.5	62.1	69.8	75.2	
BV	220.8	246.0	259.7	271.7	
DPS	24.3	22.7	41.2	47.7	
Cash Per Share	32.8	59.0	74.6	89.8	
Operating Ratios (%)					
EBIT Margin	20.6	19.1	19.1	19.2	
PBT Margin	21.4	19.9	20.2	19.8	
PAT Margin	16.5	15.0	15.2	15.0	
Debtor days	66	66	66	66	
Return Ratios (%)					
RoE	20.8	19.5	21.1	21.9	
RoCE	23.5	23.0	25.1	26.2	
RoIC	29.2	31.6	36.2	40.9	
Valuation Ratios (x)					
P/E	29.1	27.8	24.3	22.4	
EV / EBITDA	18.0	16.8	14.9	13.4	
EV / Net Sales	4.6	3.9	3.4	3.1	
Market Cap / Sales	4.8	4.2	3.7	3.4	
Price to Book Value	6.0	5.4	5.1	4.9	
Solvency Ratios					
Debt/EBITDA	0.2	0.2	0.1	0.1	
Debt/EBITDA	0.2	0.2	0.1	0.1	
Current Ratio	1.6	1.6	1.6	1.6	
Quick Ratio	1.6	1.6	1.6	1.6	

Source: Company, ICICI Direct Research

Exhibit 11: ICICI Direct coverage universe (IT)

Company Name	CMP	TP (₹)	Rating	Mcap (₹)	EPS (₹)			P/E			RoCE (x)			RoE(x)		
					FY21	FY22E	FY23E	FY21	FY22E	FY23E	FY21	FY22E	FY23E	FY21	FY22E	FY23E
HCL Tech (HCLTEC)	1,330	1,430	HOLD	360,917	45.8	48.0	54.9	29.0	27.7	24.2	23.5	23.0	25.1	20.8	19.5	21.1
Infosys (INFTEC)	1,897	2,300	BUY	806,433	45.5	55.9	63.2	41.7	34.0	30.0	31.7	34.5	36.4	25.2	28.2	29.8
TCS (TCS)	3,965	4,600	BUY	1,467,050	87.6	104.0	120.9	45.2	38.1	32.8	45.9	49.0	51.7	37.5	41.4	43.4
Tech M (TECMAH)	1,719	2,150	BUY	166,107	50.2	64.7	76.8	34.2	26.6	22.4	19.8	22.8	24.4	17.8	20.4	21.4
Wipro (WIPRO)	640	750	BUY	350,528	19.1	21.8	25.6	33.6	29.4	25.0	21.3	22.5	26.2	19.5	21.6	25.4
LTI (LTINFNC)	7,100	7,650	BUY	124,646	111.0	137.3	169.9	64.0	51.7	41.8	31.9	33.0	34.0	26.5	27.6	28.5
Mindtree (MINCON)	4,558	4,915	HOLD	75,069	67.4	89.8	109.2	67.6	50.7	41.7	32.5	36.0	36.3	25.7	28.2	28.2
Coforge (NIITEC)	5,726	5,870	BUY	35,595	73.3	115.2	146.7	78.1	49.7	39.0	23.3	28.6	30.9	18.5	25.0	27.1
TeamLease (TEASER)	4,249	4,220	HOLD	7,291	46.5	66.7	101.0	91.4	63.7	42.1	14.2	16.3	19.9	11.6	15.7	18.7
Infoedge (INFEDG)	5,589	6,270	BUY	72,413	20.9	37.1	51.0	267.3	150.7	109.7	7.7	13.1	16.7	6.0	9.9	12.6

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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