



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	✓	↔	✓

ESG Disclosure Score

NEW

ESG RISK RATING
Updated Jan 08, 2022

16.59

Low Risk

NEGL	LOW	MED	HIGH	SEVERE
0-10	10-20	20-30	30-40	40+

Source: Morningstar

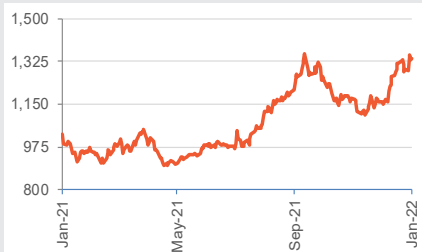
Company details

Market cap:	Rs. 3,62,966 cr
52-week high/low:	Rs. 1,377 / 890
NSE volume: (No of shares)	47.8 lakh
BSE code:	532281
NSE code:	HCLTECH
Free float: (No of shares)	107.6 cr

Shareholding (%)

Promoters	60.3
FII	22.8
DII	12.9
Others	3.9

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	16.5	6.9	28.6	30.1
Relative to Sensex	10.6	7.1	13.4	6.7

Sharekhan Research, Bloomberg

HCL Technologies

Healthy Q3; closing in on large peers

IT & ITES

Sharekhan code: HCLTECH

Reco/View: Buy



Upgrade



Maintain



Downgrade

CMP: Rs. 1,338

Price Target: Rs. 1,550



Summary

- HCL Technologies surprised positively with outstanding revenue growth performance, but profitability missed our estimates; Q3 saw healthy deal bookings, strong hiring, good cash flow conversion and client additions.
- The management reiterated its earlier guidance of a double-digit CC revenue growth. However, it lowered EBIT margin guidance to 19% from 19-21% earlier, owing to higher attrition, investments & normalisation of product business margins.
- HCL Tech is expected to narrow gap versus large peers in terms of revenue growth in FY2023 given continued strength in services business, strong deal intake and improvement in growth profile of products business
- We maintain a Buy on HCL Technologies with a revised PT of Rs. 1,550, given strong growth momentum in services business, leadership in ERD market, robust hiring and reasonable valuations.

HCL Technologies (HCL Tech) reported stellar revenue growth of 7.6% q-o-q (highest in last 46 quarters) on constant currency (CC) terms, led by strong recovery in its product business and continued strength in its services business. Further, order bookings, robust hiring, healthy client metrics and cash flow conversion remained impressive. The management remains confident that strong demand would sustain going ahead. HCL Tech is expected to narrow the gap with large peers in terms of revenue growth in FY2023 given strength in services, strong deal intake and improvement in the growth profile of products business. However, supply-side challenges, investments in frontline sales & building capabilities, rising expenses to backfill attrition, increasing discretionary expenses and growth related wage hikes would continue put pressure on margin of services business in the near term.

Key positives

- Stellar CC revenue growth of 7.6% q-o-q, higher than our estimates and street's as well
- Strong comeback of products business, up 24.5% q-o-q in CC terms
- FCF grew by 34% q-o-q with FCF/EBITDA of 75% (versus 60% in Q2FY22)

Key negatives

- EBIT margin of IT and business services declined 220 bps q-o-q
- Attrition inched up by 410 bps q-o-q to 19.8%

Management Commentary

- Retained earlier guidance of double-digit revenue growth for FY2022E in CC terms
- Maintained product business revenue growth guidance of 0-1% for FY2022
- Lowered EBIT margin guidance to 19% from 19-21% earlier for FY2022

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 revised PT of Rs. 1,550: We believe the company's strength in digital foundation and application modernisation, new geography expansion, investments in building capabilities to capture opportunities in cloud space and record hiring would help HCL Tech drive growth in FY2023 and reduce gap versus large peers in terms of revenue growth. Though margins could remain under pressure in the near term, levers such as strong growth, pyramid management, expansion into low-cost smaller cities, automation and pricing leverage would help defend margins in FY2023E. At CMP, the stock trades at a reasonable valuation of 23x/21x its FY2023E/FY2024E earnings, at a sharp discount to large peers. Hence, we maintain a Buy on the stock with a revised PT of Rs. 1,550.

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	85,517.4	97,769.9	1,08,985.4
OPM (%)	26.6	23.6	23.7	23.8
Adjusted PAT	13,010.0	13,203.5	15,045.0	16,916.9
% YoY growth	17.6	1.5	13.9	12.4
Adjusted EPS (Rs.)	47.9	50.1	57.0	64.1
P/E (x)	27.9	26.7	23.4	20.9
P/B (x)	6.0	5.7	5.4	5.1
EV/EBITDA (x)	17.5	17.7	15.6	14.0
RoNW (%)	23.3	21.4	23.0	24.3
RoCE (%)	25.0	23.6	26.1	27.9

Source: Company; Sharekhan estimates

Stellar revenue growth, but margins off mark

HCL Technologies delivered better-than-expected revenue growth of 7.6% q-o-q (highest in last 47 quarters) and 15.0% y-o-y on CC basis, led by all-round growth across verticals (especially strong double-digit growth in technology, retail and telecom) and robust revenue recovery in products business. Services business' (accounted for 86.5% of total revenues) revenue growth momentum continued to be strong at 5.3% q-o-q and 16.1% y-o-y during the quarter, aided by strong 8.3%/19.7% q-o-q/y-o-y revenue growth in engineering & R&D services (ERS) and a robust 4.7%/15.3% q-o-q/y-o-y revenue growth in IT and business services. Product & platform (P&P) business revenue recovered strongly at 24.5%/8.2% q-o-q/y-o-y on CC, led by recouping revenue from the licensing deals that were delayed in previous quarter and strong seasonality. Mode-2 services delivered stellar CC revenue growth of 6.1% q-o-q and 30.2% y-o-y because of traction in digital engineering, acceleration in application modernization and higher cloud transformation deals. EBIT margins remained flat at 19%, below our estimates, owing to wage hike (-80 bps), weak seasonality including lower billing days (-65 bps), ramping up news contracts and investments (-40 bps) and higher cost to backfill attrition and higher bonus (-85 bps). These margin headwinds were partially offset by operating leverage (+60bps) and currency tailwinds (+20bps). EBIT margins of the ERS and product businesses contracted by 220 bps q-o-q and 70 bps q-o-q respectively, while EBIT margin in P&P business improved to 31.9% from 19.4%/30.6% in Q2FY2022/Q3FY2021. Net profit of Rs. 3,443 crore (up 5.5% q-o-q, but down 13.5% y-o-y) was above our estimates led by strong revenue beat, partially offset by miss in operating profitability and higher tax provision. Cash conversion in terms of free cash flow (FCF) to net profit and FCF to EBITDA ratios improved q-o-q to 114% and 75%, respectively.

Q3FY2022 Key earnings call highlights

- ♦ **Product revenue recovered strongly:** HCL Tech' revenue growth performance beat our and street's estimates as well, led by robust recovery in product revenues. Products & platforms business revenue grew by 24.5% q-o-q and 8.2% y-o-y on a CC basis, driven by seasonal tailwinds and recouping of lost revenue of the previous quarter. Though all the products performed well during the quarter, it saw excellent growth in commerce, digital experience, marketing and security offerings. These products had very good deal wins during the quarter. Enterprises are making consolidated digital platform investments, which would be beneficial to HCL software business. HCL Tech's product business has more than 15000 clients. Its product business annualized revenue run-rate is at around \$1.5 billion. However, Q4 of a fiscal year is usually seasonally weak quarter for the product business, hence we expect a sharp sequential decline in its product business in Q4FY2022. The management maintained its earlier FY2022 revenue growth guidance of 0-1% for P&P business.
- ♦ **Strong demand environment in services business:** The company's services business continued its strong growth momentum at 5.3% q-o-q on CC terms. The demand trends in its services business are - (1) a large number of small-sized deals and shorter duration programs in digital business (especially in front-office transformation), (2) talent supply gap in enterprises leading to higher outsourcing deals, (3) momentum in ERS business led by Industry 4.0, IoT, semiconductor and telecom network transformation, (4) cloud remain a key catalyst across the industries. The company launched 40 new solutions under cloud business during the quarter.
- ♦ **Strong growth in IT & business services segment to continue:** IT&BS revenue grew by 4.7% q-o-q in Q3FY2022, led by strong growth in the Cloud business. The cloud transformation has three phases such as 1) migration to cloud, 2) modernization of application and data and 3) building more innovation. The company participates in all these three areas. Hence, management believes that the strong growth momentum in the IT & business services segment to continue going ahead.
- ♦ **Strong demand outlook:** The management remains confident of sustainability of strong demand environment going ahead. The company's strength in digital foundation and modern applications, investments in application capability and talent supply capability position the company to capture a reasonable share of market opportunity. This reflects the company's strong deal win TCVs over last three quarters. Though Q4 will be a seasonally weak quarter for its product business, we believe company would report sequential revenue growth on the back of strong growth momentum in services business. Despite strong revenue recovery in product and platform business, management maintained its P&P business revenue growth guidance of 0-1% y-o-y for FY2022.

- ♦ **Margin guidance lowered for FY2022:** The management revised downward its EBIT margin guidance to 19% for FY2022 from earlier guidance of 19-21%. During Q3FY2022, the company's services business EBIT margin impacted due to wage revision, investments, weak seasonality and higher cost to backfill attrition. Supply side challenges, investments in frontline sales and building capabilities, rising expenses to backfill attrition and growth related wage hikes would continue put pressure on margin of services business in the near term. Further, products business margin would decline in Q4FY2022 on the back of soft seasonality. As a result, overall profitability of the company would remain under pressure in the near-term. Management also indicated that FY2022 EBIT margin could further decline by 10-20bps from the level of 19% in case of higher investments.
- ♦ **Healthy order bookings and order pipeline:** HCL Tech signed 16 large net new deals across both services and products business. New deal TCVs remained at \$2.14 billion, increasing 64% y-o-y (down 5% q-o-q). Given its capabilities in both infrastructure and application business, the company is able to win integrated deals that improves its positioning in digital transformation. During the quarter, services deal TCVs grew by 63% y-o-y to \$1,968 million, while products business deal TCVs grew by 70% y-o-y to \$167 million.
- ♦ **Strong net headcount addition, attrition inched up:** Headcount increased by a net 10,143 on a sequential basis to 197,777. Management cited that it had started its talent journey much ahead of the demand cycle. HCL Tech is on track to reach 24,000 fresher hire target in FY2022. Of which, the company has recruited 15,000 freshers during 9MFY2022. The company intends to double its fresher hiring in FY2023, led by strong demand environment. The company plans to hire 2,000 graduates in the USA in the next 2-3 years. Attrition rate stood at 19.8% in Q3FY2022 versus 15.7% in Q2FY2022. The management indicated that attrition rate would remain elevated in coming quarters considering a strong demand environment and supply-side issues.
- ♦ **Strong client additions:** Number of clients in \$50 million and \$20 million clients improved on sequential (up 1 each) and y-o-y (up 11 and 13, respectively) basis. The company also added 8 and 17 clients on a sequential basis in its \$10 million and \$5 million client category. This reflects a strong broad-based demand and relevance 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, new deals have a slightly higher pricing structure.
- ♦ **Dividend payout:** HCL Tech maintained its interim dividend at Rs.10 per share. Last quarter, 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.
- ♦ **Acquisitions:** The company signed a definitive agreement to acquire Starschema, a leading provider of data engineering services, for a consideration of \$42.5 million (3.1x of EV/sales). The strategic acquisition will bolster HCL Tech's capability in digital engineering and increase its presence in Central and Eastern Europe. Following the acquisition, HCL Tech will be able to offer data engineering consulting and near-shore access to digital engineering services to a wide base of clients. Starschema generated \$13.6 million in CY2020.
- ♦ **Strong cash generation:** Free cash flow (FCF) stood at \$521 million (vs \$390 million in Q2FY22) with FCF to net income ratio at 114% (vs 88% in Q2FY22). Net cash stood at \$2,140 million versus \$2,171 million in Q2FY2022. Management stated that the company was able to manage cash despite \$341 million cash outflow during the quarter. The major cash outflows were – (1) additional dividend (\$146 million), (2) acquisition of 19.6% stake in Actian for \$100 million and (3) purchase of treasury shares of worth \$95 million.

Results

Rs cr

Particulars	Q3FY22	Q3FY21	Q2FY22	Y-o-Y %	Q-o-Q %
Revenue (\$ mn)	2,977.5	2,616.6	2,790.7	13.8	6.7
Net sales	22,331.0	19,302.0	20,655.0	15.7	8.1
Direct costs	13,928.0	11,195.0	12,758.0	24.4	9.2
Gross profit	8,403.0	8,107.0	7,897.0	3.7	6.4
Research & development	381.0	356.0	369.0	7.0	3.3
SG&A	2,780.0	2,309.0	2,690.0	20.4	3.3
EBITDA	5,242.0	5,442.0	4,838.0	-3.7	8.4
Depreciation and amortisation	991.0	1,027.0	922.0	-3.5	7.5
EBIT	4,251.0	4,415.0	3,916.0	-3.7	8.6
Forex gain/(loss)	73.0	2.0	79.0	-	-7.6
Other income	130.0	124.0	128.0	4.8	1.6
PBT	4,454.0	4,541.0	4,123.0	-1.9	8.0
Tax provision	997.0	544.0	846.0	83.3	17.8
Net profit	3,443.0	3,981.0	3,264.0	-13.5	5.5
Adjusted net profit	3,443.0	3,981.0	3,264.0	-13.5	5.5
EPS (Rs.)	13.1	14.7	12.4	-11.0	5.5
Margin (%)				BPS	BPS
EBITDA	23.5	28.2	23.4	-472	5
EBIT	19.0	22.9	19.0	-384	8
NPM	15.4	20.6	15.8	-521	-38
Tax rate	22.4	12.0	20.5	1,040	187

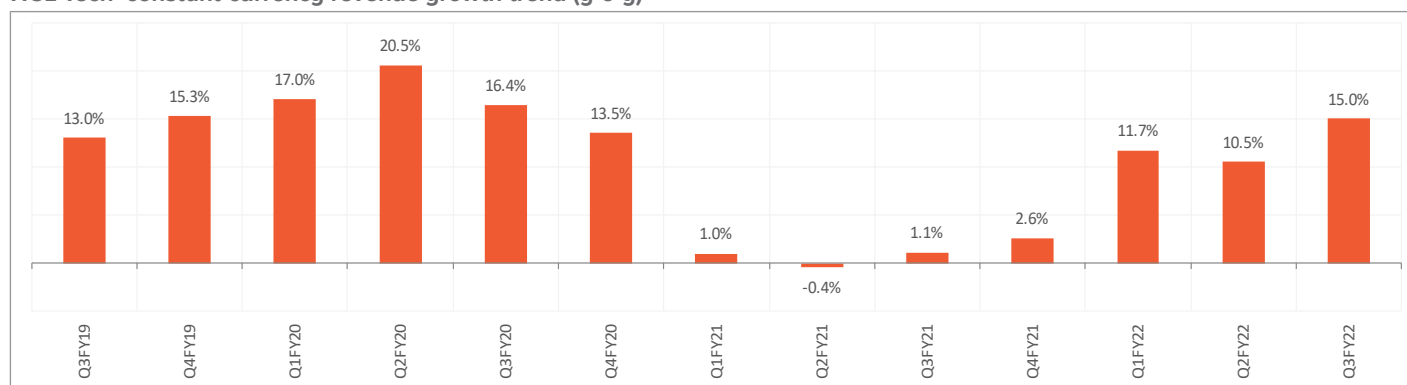
Source: Company; Sharekhan Research

Revenue mix: Geographies, industry verticals and other operating metrics

Particulars	Revenues	Contribution	\$ Growth (%)		CC growth (%)	
	(\$ mn)	(%)	Q-o-Q	Y-o-Y	Q-o-Q	Y-o-Y
Revenues (\$ mn)	2,978	100	6.7	13.8	7.6	15.0
Geographic mix						
Americas	1,879	63.1	7.2	14.9	7.3	15.0
Europe	843	28.3	6.7	9.2	9.1	12.0
RoW	259	8.7	4.3	23.7	4.5	25.8
Industry verticals						
Financial services	628	21.1	5.7	12.2	6.3	13.5
Manufacturing	521	17.5	4.3	10.0	5.7	12.2
Technology & services	548	18.4	14.1	17.6	14.0	18.1
Retail & CPG	301	10.1	10.0	9.5	11.5	11.5
Telecommunications, media, publishing & entertainment	241	8.1	9.4	11.1	11.3	12.4
Lifesciences & healthcare	429	14.4	0.4	20.5	0.9	21.3
Public services	310	10.4	4.7	13.8	6.1	14.8
Service line						
IT and business services	2,103	70.6	3.8	14.2	4.7	15.3
Engineering and R&D Services	473	15.9	8.0	16.6	8.3	19.7
Products & platforms	402	13.5	23.1	9.0	24.5	8.2
Clients Contribution						
Top 5	363	12.2	2.5	2.8	-	-
Top 10	604	20.3	4.6	10.0	-	-
Top 20	875	29.4	4.9	8.3	-	-

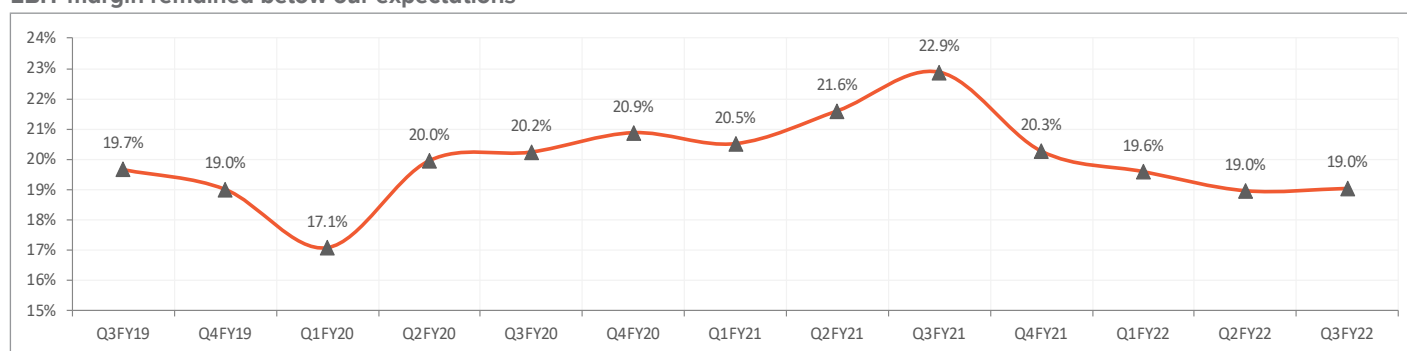
Source: Company; Sharekhan Research

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



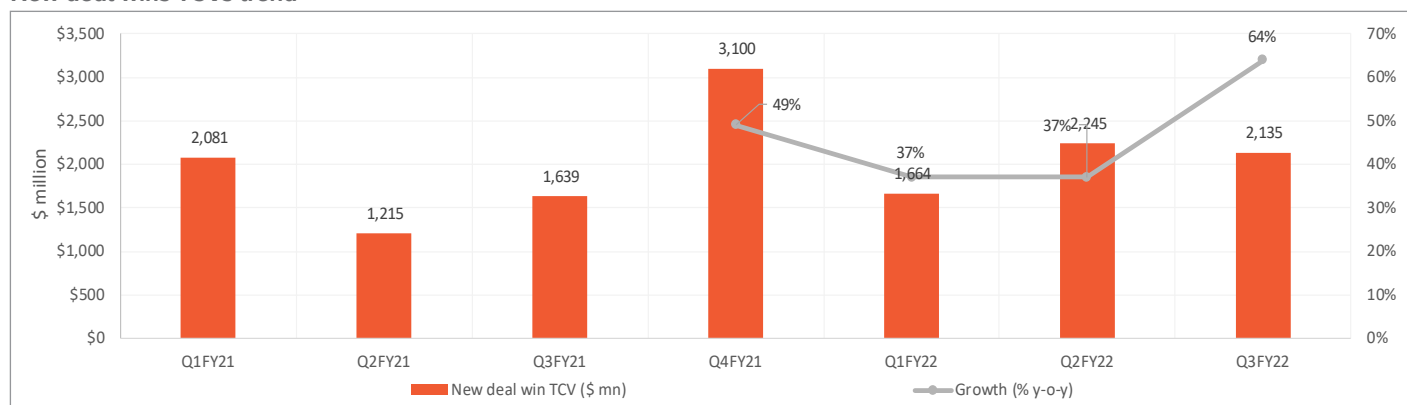
Source: Sharekhan Research

EBIT margin remained below our expectations



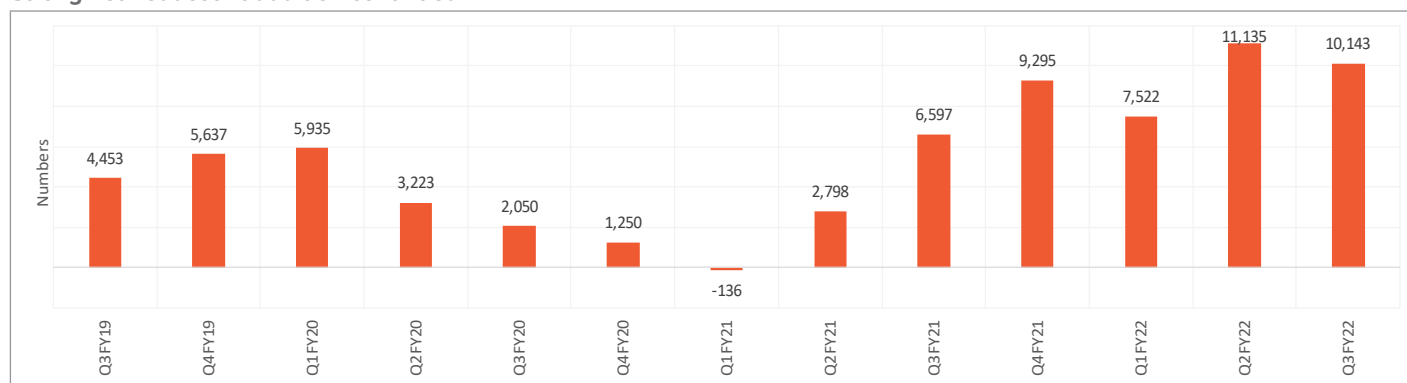
Source: Sharekhan Research

New deal wins TCVs trend



Source: Sharekhan Research

Strong net headcount addition continued



Source: Sharekhan Research

Outlook and Valuation

■ Sector view – Expect acceleration in technology spending going forward

We believe the need for business continuity, operational resilience, and the switch to digital transactions have led to strong demand for IT services post the pandemic. Industry analysts such as Gartner estimate that IT services spending would grow by 8-8.5% in the next four years as compared to the average of 4.2% achieved over the past 10 years. 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.

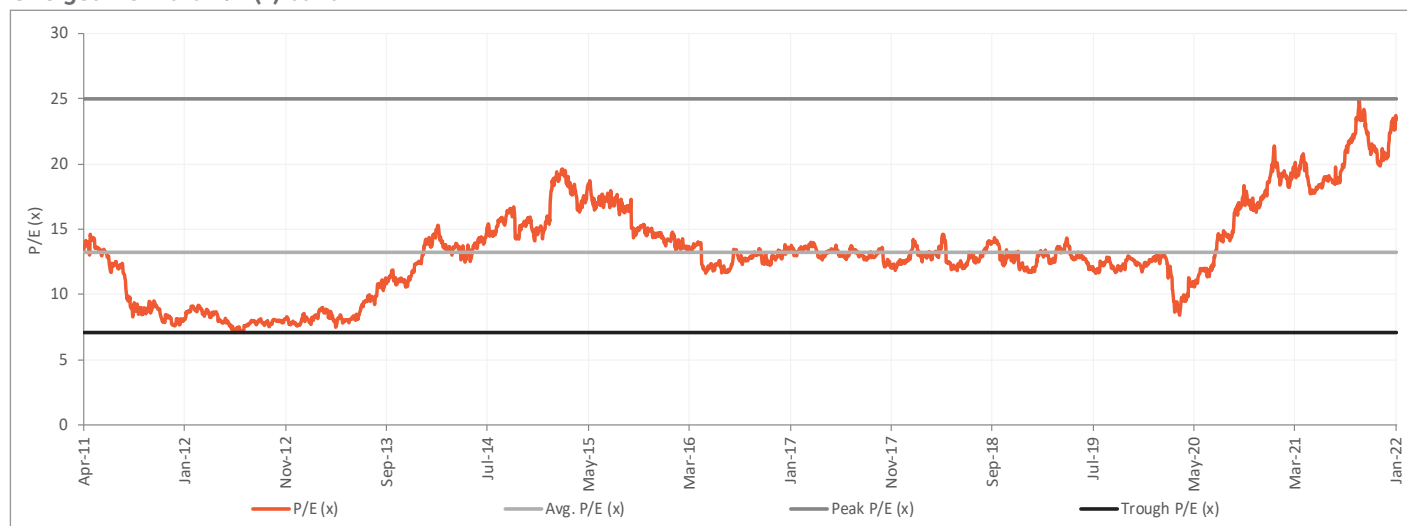
■ Company outlook – Growth on recovery path

HCL Tech has invested aggressively in the fast-growing Mode-2 (a good proxy for digital offering) capabilities, which would help HCL Tech to deliver strong revenue growth in the coming years. Given its differentiated position in IMS and strong capabilities in engineering services, HCL Tech is well positioned to maintain its growth momentum in the IT services business (87% of total revenue) going ahead. HCL Tech's strength in digital foundation and application modernization make it a strong contender for building out digital transformation initiatives for clients.

■ Valuation – Maintain Buy with a PT of Rs. 1,550

We believe the company's strength in digital foundation and application modernisation, new geography expansion, investments in building capabilities to capture opportunities in cloud space and record hiring would help HCL Tech drive growth in FY2023 and reduce gap versus large peers in terms of revenue growth. Though margins could remain under pressure in the near term, levers such as strong growth, pyramid management, expansion into low-cost smaller cities, automation and pricing leverage would help defend margins in FY2023E. At CMP, the stock trades at a reasonable valuation of 23x/21x its FY2023E/FY2024E earnings, at a sharp discount to large peers. Hence, we maintain a Buy on the stock with a revised PT of Rs. 1,550.

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 (%)	
				FY22E	FY23E	FY22E	FY23E	FY22E	FY23E	FY22E	FY23E
Infosys	1,928	421	8,10,927	36.5	31.2	24.9	21.5	5.5	5.1	27.5	29.9
TCS	3,969	370	14,68,246	38.3	32.9	27.2	23.4	16.5	16.1	43.6	49.5
Wipro	640	548	3,50,694	28.7	25.7	19.4	16.6	6.1	5.5	19.7	20.9
HCL Tech	1,338	271	3,62,966	26.7	23.4	17.7	15.6	5.7	5.4	21.4	23.0

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 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 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	Managing Director & CEO
Prateek Aggarwal	Chief Financial Officer
Apparao V V	Chief Human Resources Officer
Kalyan Kumar	Chief Technology Officer and Head, Ecosystems

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	SBI Funds Management Private Limited	2.37
2	Life Insurance Corp of India	2.34
3	Artisan Partners LP	1.81
4	ICICI Prudential Asset Management	1.67
5	BlackRock Inc	1.54
6	The Vanguard Group Inc.	1.46
7	Aditya Birla Sun Life Asset Management	0.71
8	Nippon Life India Asset Management Limited	0.62
9	Vontobel Holding AG	0.60
10	Norges Bank	0.59

Source: Bloomberg

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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 deteriorating 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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