Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

HCL Technologies

Eyeing new growth opportunities

IT & ITES	Sharekhan code: HCLTECH	Company Update

Stock 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. 991**	
Price Target: **Rs. 1,200**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

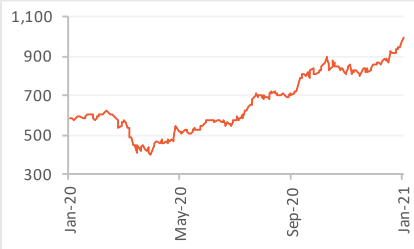
Company details

Market cap:	Rs. 2,68,992 cr
52-week high/low:	Rs. 995 / 375
NSE volume: (No of shares)	85.4 lakh
BSE code:	532281
NSE code:	HCLTECH
Free float: (No of shares)	54.3 cr

Shareholding (%)

Promoters	60.3
FII	25.4
DII	11.1
Others	3.2

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	15.9	19.6	71.3	70.3
Relative to Sensex	9.3	(2.8)	38.6	51.3

Sharekhan Research, Bloomberg

Summary

- We maintain a Buy on HCL Technologies with a revised PT of Rs. 1200 as stock trades at a discount to Wipro despite a better growth profile in past few years.
- COVID-19 has catalysed demand for cloud transformation, intelligent workspaces and cybersecurity, which present huge opportunities.
- USD revenue growth seen at 3.1% q-o-q and 2.7% q-o-q in constant currency terms in Q3FY2021, ahead of its growth guidance of 1.5-2.5%; margins to decline 40 bps q-o-q on partial wage revisions
- Strong order bookings, healthy deal pipeline and consolidation opportunities in both IMS and application modernisation would drive growth going ahead.

HCL Technologies' (HCL Tech's) strength in the digital business and greater focus on building capabilities in this area would help the company to capture the transformational opportunities. COVID-19 has catalysed demand for cloud transformation, intelligent workspaces and collaboration tools and cybersecurity, which would create significant opportunities for HCL Tech given its expertise in both IMS and application modernisation. Further, broad trends such as reimagining customer experience, Artificial Intelligence led services, building resiliency in operations, emergence of new business models, cost-savings and a fluid workplace framework are expected to create phenomenal growth opportunities for leading tier-I companies including HCL Technologies. The company's management also believes that higher cloud adoption, increasing digital transformation by enterprises and a digital workspace model would be key growth drivers for the company. Given its comprehensive, end-to-end digital offerings to address core spends and digital transformation needs of large corporations, HCL Tech is well-positioned to deliver double-digit growth in FY2022E and FY2023E. HCL Technologies has provided a revenue growth guidance of 1.5-2.5% q-o-q for Q3 and Q4 of FY2021 and EBIT margin guidance of 20-21% for FY2021. We expect HCL to report USD revenue growth of 3.1% q-o-q and 2.7% q-o-q in constant currency terms, beating its growth guidance. Revenue growth is expected to be driven by broad-based growth across IT and business services, ERD and products & platforms. We expect EBIT margins to decline by 40 bps q-o-q to 21.2%, owing to wage revision for part of the employees from October 2020. We assume that HCL Tech would raise its revenue guidance band for FY2021E. We expect HCL Tech's growth over next few years would be driven by higher digital transformation, increasing spending on Cloud-related technologies and strong deal wins.

Our Call

Valuation – Maintain Buy with a revised PT of Rs. 1,200: We believe HCL Tech's infrastructure and application capabilities are expected to drive its overall growth in this cloud adoption environment. Further, strong order bookings, a healthy deal pipeline, and higher spends on digital transformation are expected to support company's growth going forward. With improving free cash flow (FCF) generation, we expect management would increase its payout ratio in coming years. At CMP, the stock trades at 18x/16x of its FY2022E/FY2023E earnings, at a discount to its large peers including Wipro, despite good margin defense and strong growth profile as compared to Wipro over last few years. Hence, we maintain our Buy rating on the stock with a revised PT of Rs. 1,200.

Key risk

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.

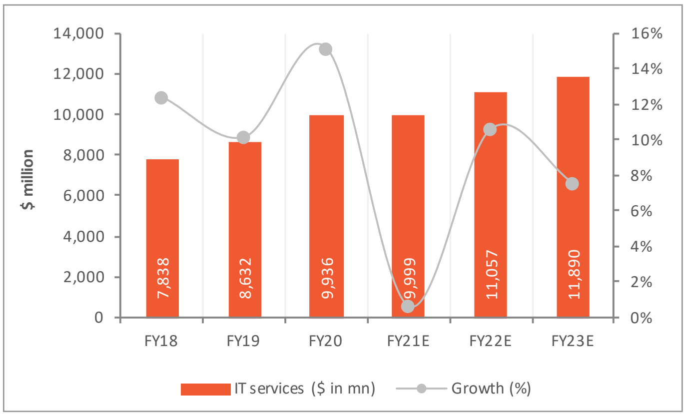
Valuation Rs cr

Particulars	FY19	FY20	FY21E	FY22E	FY23E
Revenue	60,427.0	70,678.0	74,958.5	83,482.7	90,956.7
OPM (%)	23.1	23.6	25.9	25.0	24.9
Adjusted PAT	10,123.0	11,061.0	12,332.5	13,419.0	14,752.1
% YoY growth	*15.3*	*9.3*	*11.5*	*8.8*	*9.9*
Adjusted EPS (Rs.)	36.8	40.8	45.5	49.5	54.4
P/E (x)	24.2	21.9	19.6	18.0	16.4
P/B (x)	3.1	4.7	4.2	3.8	3.8
EV/EBITDA (x)	17.0	14.5	12.5	11.6	10.0
RoNW (%)	26.0	23.8	22.7	22.1	23.1
RoCE (%)	29.2	25.3	24.9	24.8	26.1

Source: Company; Sharekhan estimates

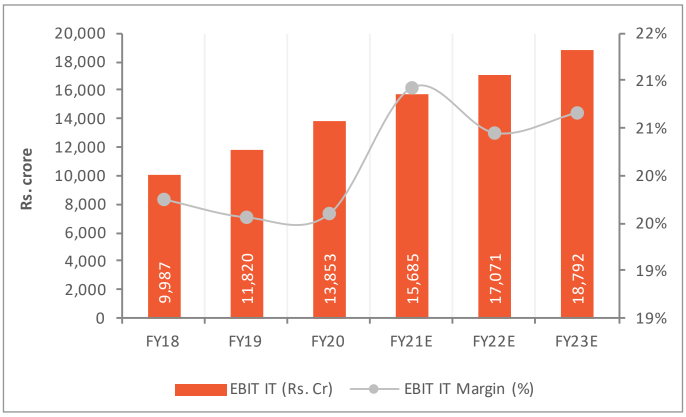
Financials in charts

Revenue in US$ (mn) and growth (%)



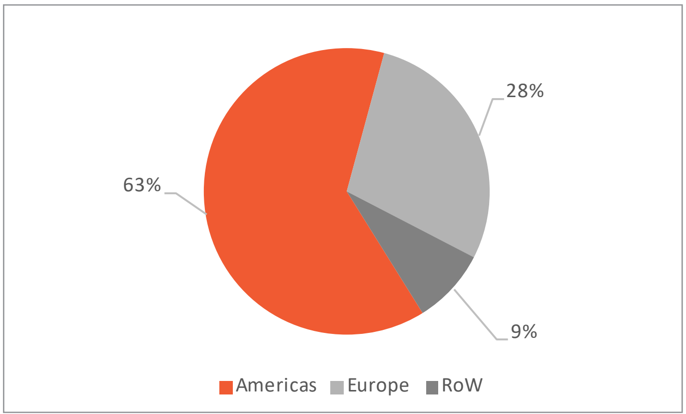
Source: Company, Sharekhan Research

EBIT (Rs. cr) and EBIT margin (%)



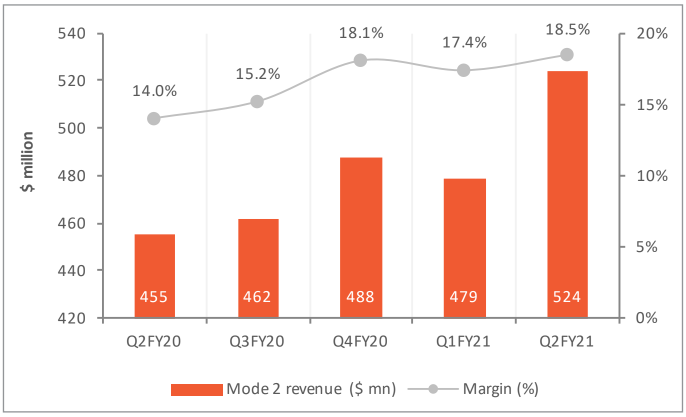
Source: Company, Sharekhan Research

Geograpghy break-up (%)



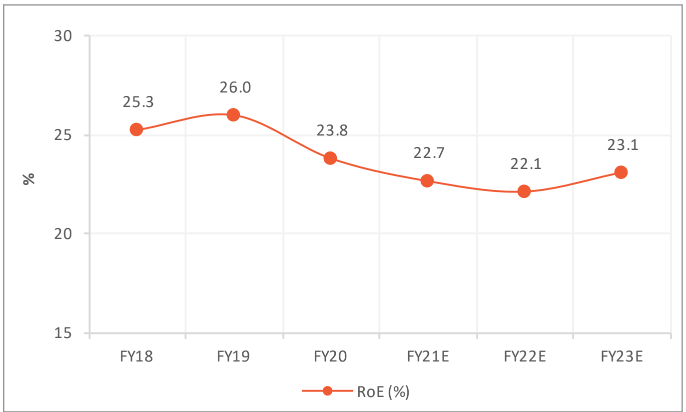
Source: Company, Sharekhan Research

Mode-2 revenue and margin (%)



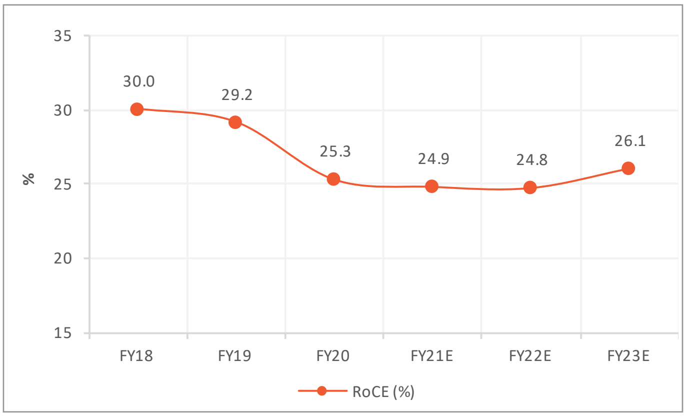
Source: Company, Sharekhan Research

RoE trend (%)



Source: Company, Sharekhan Research

RoCE trend (%)



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector View – Expect acceleration in technology spending going forward

Industry analysts such as Gartner estimate IT services spending would grow by 5-8% over CY2021-CY2024E compared to average of 4.2% achieved in CY2010-CY2019. Forecasts indicate higher demand for cloud infrastructure services, potential increase in specialised software, potential investments in transformation projects by clients, and increased online adoption across verticals. Implications from the outbreak of the pandemic have accelerated digital activities among large global enterprises, leading to increased spending on workplace transformation and collaboration tools, cyber-security, and higher cloud migration. Higher hybrid cloud adoption is a good tailwind for IMS business as the client would invest in digital foundation (includes security and an automated operating model) and application modernisation.

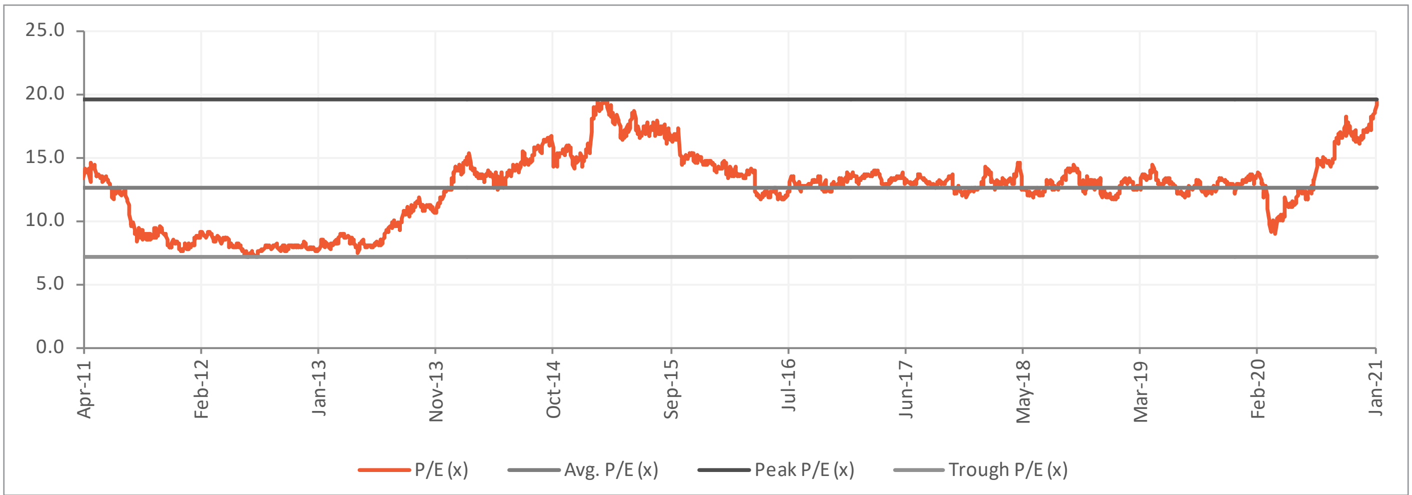
■ Company Outlook – Growth recovery ahead

The management has raised its revenue and margin guidance for Q2FY2021 as COVID-19's impact on the demand side has stabilised and the order book and deal pipeline remain strong. Further, HCL Tech has invested aggressively in the fast-growing Mode-2 (a good proxy for digital offering) capabilities, which would help HCL Tech to match the industry's growth. The company has made large investments towards the acquisition of IP products to diversify its focus on new high-margin revenue streams. The addressable market opportunity for IMS is huge, with only 10-12% penetration of the addressable market. Given its differentiated positioning in IMS and strong capabilities in engineering services, HCL Tech is well positioned to maintain growth momentum in these segments going ahead.

■ Valuation – Maintain Buy with a revised PT of Rs. 1200

We believe HCL Tech's infrastructure and application capabilities are expected to drive its overall growth in this cloud adoption environment. Further, strong order bookings, a healthy deal pipeline, and higher spends on digital transformation are expected to support company's growth going forward. With improving free cash flow (FCF) generation, we expect management would increase its payout ratio in coming years. At CMP, the stock trades at 18x/16x of its FY2022E/FY2023E earnings, at a discount to its large peers including Wipro, despite good margin defense and strong growth profile as compared to Wipro over last few years. Hence, we maintain our Buy rating on the stock with a revised PT of Rs. 1,200.

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/EBITDA (x)		P/BV (x)		RoE (%)	
				FY21E	FY22E	FY21E	FY22E	FY21E	FY22E	FY21E	FY22E
TCS	3,092	375	1,160,350	35.3	31.2	25.7	23.1	13.1	12.1	38.0	40.4
Tech M	1,004	97	97,139	21.5	18.6	13.6	11.5	3.6	3.2	17.9	18.6
Wipro	405	573	232,128	23.3	21.9	16.0	14.8	4.1	3.7	15.7	15.8
HCL Tech	991	271	268,992	21.8	20.0	13.9	13.0	4.7	4.2	22.7	22.1

Source: Company, Sharekhan Research

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 IMS. 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 deals. 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	President & CEO
Prateek Aggarwal	Chief Financial Officer
G H Rao	President – Engineering and R&D Services
Rahul Singh	President – Financial Services

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Life Insurance Corp of India	2.31
2	SBI Funds Management Pvt Ltd	2.10
3	Artisan Partners LP	1.50
4	Vanguard Group Inc/The	1.43
5	BlackRock Inc	1.43
6	ICICI Prudential Asset Management	0.96
7	Nomura Holdings Inc	0.83
8	Vontobel Holding AG	0.77
9	Virtus Investment Partners Inc	0.69
10	Norges Bank	0.64

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

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