Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

HCL Technologies

Weak Q4; deals wins to power growth

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. 956**	
Price Target: **Rs. 1,200**	↓

↑ Upgrade ⟷ Maintain ↓ Downgrade

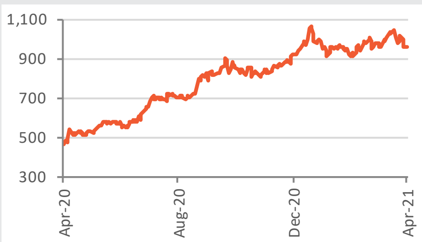
Company details

Market cap:	Rs. 2,59,372 cr
52-week high/low:	Rs. 1,073 / 463
NSE volume: (No of shares)	67.3 lakh
BSE code:	532281
NSE code:	HCLTECH
Free float: (No of shares)	107.6 cr

Shareholding (%)

Promoters	60.3
FII	24.1
DII	10.6
Others	5.0

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-2.5	-3.8	9.8	104.0
Relative to Sensex	1.8	-0.2	-7.9	51.2

Sharekhan Research, Bloomberg

Summary

- We maintain a Buy rating on HCL Technologies with a revised PT of Rs. 1,200, given clients' rising spends on Cloud-related technologies and reasonable valuations.
- Q4 numbers missed headline estimates; but deal bookings, employee additions and healthy cash generation remained impressive; EBIT margins shrunk by 260 bps q-o-q owing to a wage hike and a seasonal decline in the product business.
- The management guided for a double-digit revenue growth on CC terms (versus our estimates of 10-12%) and OPM of 19-21% (versus our expectations of 20-21%). Margin likely to be affected owing to investments in geographies, capabilities and talents.
- Expect strong double-digit revenue growth in FY2022 despite lower growth in product business, driven by robust deal wins, deal pipeline and rising spends on transformation initiatives by clients.

HCL Technologies' (HCL Tech) headline numbers remained below our expectations in Q4FY21 owing to higher-than-expected seasonal decline in product business, while order bookings, employee additions and higher dividend payments remained impressive. The company reported a q-o-q revenue growth of 2.5% (at the mid-point of the company's growth guidance of 2-3% for Q4FY2021) on constant currency (CC), below our estimates. A sequential revenue growth was driven by a 4.4% q-o-q CC revenue growth in IT & Business Services, while the products & platforms (P&P) segment's CC revenue growth declined 4.9% q-o-q owing to weak seasonality. US Dollar revenues grew by 3% q-o-q (including 0.9% revenue growth contribution from DWS acquisition) and 6% y-o-y to $2,695.9 million, below our estimates. EBIT margin (excluding one-time special incentive) was down 261bps q-o-q to 20.3%, owing to wage revision, seasonal decline in P&P revenue, fresher hiring and other investments and forex. Reported EBIT margin stood at 16.6%, below our estimates. Adjusted net profit of Rs. 2,962 crore (down 25.6% q-o-q and 6.1% y-o-y) was ahead of our estimates, aided by a rise in other income, but was offset by higher tax provision. HCL Tech signed 19 transformative deals across the verticals and new deal TCVs remained at an all-time high during this quarter at $3.1 billion, up 49% y-o-y. For FY2021, new Deal TCVs are $7.3 billion, grew 18% y-o-y, provide revenue visibility for FY2022. The management guided double digit revenue growth on CC terms (versus our estimates of 10-12%) and operating margin at 19-21% (versus our expectations of 20-21%). Revenue growth would be driven by strong demand tailwinds, robust deal wins and strong traction for its IT & business unit and ERD business. However, management expects product & platform (P&P) business would at a low single digit in FY2022 as the company plans to retire couple of products where it sees decline characteristics. Management expects that margin would be impacted in FY2022 owing to another round of wage revisions, investments in geographies, Mode-2 capabilities, higher net hiring local hires and reversal of COVID-19 savings.

Key positives

- Order bookings stay strong: TCVs up 49% y-o-y at $3.1 billion
- Strong net employee addition (added 9,295 employees during Q4)

Key negatives

- P&P business revenue is expected to grow at low single digit in FY2022
- Guided lower-than-expected EBIT margin

Our Call

Valuation – Maintain Buy with revised PT of Rs. 1,200: We tweaked earnings estimates for FY2022E/FY2023E, to factor in the lag in headline estimates, lower-than-expected EBIT margin guidance, retirement of couple of products and strong deal wins. However, the strong deal bookings, a healthy deal pipeline, strong net employee addition and rising spends on transformation initiatives by clients would help HCL Tech deliver strong revenue growth in FY2022E. With improving free cash flow (FCF) generation, we expect that the management would maintain a higher payout ratio in coming quarters. At CMP, the stock trades at a reasonable valuation of 19x/17x its FY2022E/FY2023E earnings. Hence, we maintain a Buy rating on the stock with a revised PT of Rs. 1,200.

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 (Consolidated) Rs cr

Particulars	FY19	FY20	FY21	FY22E	FY23E
Revenue	60,427.0	70,678.0	75,379.0	86,883.8	96,472.4
OPM (%)	23.1	23.6	26.6	25.4	25.5
Adjusted PAT	10,123.0	11,061.0	13,010.0	13,587.9	15,325.8
% YoY growth	*15.3*	*9.3*	*17.6*	*4.4*	*12.8*
Adjusted EPS (Rs.)	36.8	40.8	47.9	50.1	56.5
P/E (x)	26.0	23.4	19.9	19.1	16.9
P/B (x)	3.3	5.0	4.3	3.9	3.5
EV/EBITDA (x)	18.4	15.5	12.8	11.7	10.4
RoNW (%)	26.0	23.8	23.3	21.4	21.8
RoCE (%)	29.2	25.3	25.0	24.4	25.2

Source: Company; Sharekhan estimates

Key Q4 indicators miss mark

HCL Tech's headline numbers remained below our expectations owing to a higher-than-expected seasonal decline in product business, while order bookings, employee addition, broadly in-line revenue growth guidance and higher dividend payment remained impressive. The company reported a q-o-q revenue growth of 2.5% (at the mid-point of the company's growth guidance of 2-3% for Q4FY2021) on a constant currency (CC) basis, below our estimate. Sequential revenue growth was driven by 4.4% q-o-q CC revenue growth in IT & Business Services, while the P&P segment's constant-currency revenue growth declined 4.9% q-o-q owing to weak seasonality. Mode-1 and Mode-2 services delivered CC revenue growth of 7.4% q-o-q and 2.4% q-o-q respectively, while Mode-3 services revenue declined 3.9% q-o-q. USD revenues grew 3% q-o-q (0.9% revenue growth contribution from DWS acquisition) and 6% y-o-y to $2,695.9 million, below our estimates. EBIT margin (excluding one-time special incentive) fell by 261 bps q-o-q to 20.3%, owing to wage revision (-60 bps), a seasonal decline in P&P revenue (-73 bps), fresher hiring and other investments (-61 bps) and forex (-21 bps). Reported EBIT margin stood at 16.6%, below our estimates. Adjusted net profit of Rs. 2,962 crore (down 25.6% q-o-q and 6.1% y-o-y) was ahead of our estimate, aided by higher other income, offset by higher tax provisions.

Q3FY2021 Key earnings call highlights

- **FY2021 performance:** The company delivered CC revenue growth of 1.1% in FY2021. In US Dollar terms, HCL Tech's revenue grew at 2.4% to $10,175 million. EBIT margin improved 180 bps y-o-y to 21.4% in FY2021. This excludes a $100 million one-time milestone bonus paid to its staffs during Q4FY2021. The growth was well balanced across all the verticals and geographies. During FY2021, HCL Tech signed a total of 58 new large deals led by industries such as financial services, life sciences and healthcare, telecommunication, manufacturing and technology.
- **Revenue growth drivers for Q4FY2021:** HCL Technologies reported a revenue growth of 3% q-o-q and 6% y-o-y in USD terms, driven by higher spends on digital, strong growth in IT and business services. The growth in the IT and business services unit was led by digital transformation deals, which includes application modernization, vertical-led operating model, analytics, cloud migration, cybersecurity and digital workplace. The company's differentiated digital transformation value proposition capability has been resonating well with clients, reflecting in the strong growth of 7.4% q-o-q and 25.2% y-o-y in the Mode-2 business on the back of higher demand for cloud native and digital programs.
- **Commentary on products & platforms business:** Q4FY2021 was a weak quarter for the P&P business, which registered a decline of 4.9% q-o-q in revenue. The management highlighted that 75% of its P&P business has a very strong growth characteristic and is likely to clock a double-digit growth in the medium term. Management expects a decline in the remaining product portfolio in FY2022. The management indicated that a couple of products could discontinue in FY2022. The company has taken an impairment charge of $16 million for one of the products that was under one of the IP partnerships.
- **Revenue and margin guidance for FY2022:** The management guided double digit revenue growth on constant currency terms (versus our estimates of 10-12%) and OPM of 19-21% (versus our expectations of 20-21%). Management believes that margins would be impacted on the back of its investments in new capabilities and reversal of COVID-related savings.
- **Business segment performance:** (1) IT and business services revenue grew 4.4% q-o-q (up 3.7% y-o-y) in CC terms, led by higher spends in digital and Cloud transformation initiatives by clients. (2) Engineering and R&D services segment's revenue increased by 0.7% q-o-q in CC (but down 2.7% y-o-y). (3) P&P segment's revenue declined by 4.9% q-o-q (up 3.3% y-o-y) on CC terms.
- **Vertical-wise performance:** The life sciences and healthcare, financial verticals and public services led overall growth, with a rise of 6.6%, 3.3% and 9.9% q-o-q in CC terms, respectively. The management citied that the underlying trends in BFSI vertical remain strong and the company participating to capture opportunities as financial services clients have been scaling-up digital programs.

- **Plans to enter into new regions:** The company plans to enter into new geographies where its sees growing demand and a significant adoption of the global delivery model. Management indicated to make investments on sales and marketing in geographies like Germany, France, Canada, Australia and Japan. The company will invest more in these adjacent countries going ahead. Management is looking at expanding into some emerging markets to address some of the IT demands in countries like Brazil, Mexico, South Korea and Spain. HCL Tech has already appointed country manager in some of these countries.
- **Wage hike:** The company would roll out next level of annual wage hike for its employees effective from Q2FY2022. Given the talent war in the industry, the company focuses to retain talents to meet the growing demand of digital technology.
- **Strong cash generation:** Free cash flow (FCF) stood at $456 million (vs $621 million in Q3FY21) with FCF to net income ratio at 94%. Net Cash stood at $2,268 million versus $2,202 million in Q3FY2021.
- **Strong order bookings and order pipeline:** HCL Tech signed 19 transformative deals across the verticals, led by financial services, life sciences and healthcare, consumer goods and manufacturing. New Deal TCV hit an all-time high this quarter at $3.1 billion, increasing 49% y-o-y. For FY2021, new deal TCVs stood at $7.3 billion, grew 18% y-o-y. The company had 8 deals in manufacturing, 4 in financial services, 3 in life sciences and health care, 2 in consumer goods and 2 in the technology vertical. The large deals are well spread between America (13 deals) and Europe (6 deals).
- **Launched CloudSmart:** The company launched CloudSmart to address the $300 billion services opportunity related to Cloud by 2023. As the company has very strong ecosystem partnerships and dedicated business units, CloudSmart would help in accelerating and maximizing business value from Cloud in alignment with industry needs and the specific organizational goals and unique client situations. HCL Tech also launched HCL Now, which is the SaaS version of all the products that it has on the HCL Software side.
- **Headcount:** Headcount increased by a net 9,295 to 168,977. Attrition rate was at an all-time low at 9.9% in Q4FY2021 versus 10.2% in Q3FY2021. The management indicated that attrition rate would inch-up in coming quarter considering strong demand environment. The company plans to hire over 15,000 entry-level hires during FY2022.
- **Effective tax rate:** The management indicated that effective tax rate for FY2022 would be in the range of 24-25%.
- **Capital allocation:** HCL Tech announced dividend of Rs. 16 per share (Interim dividend of Rs. 6 and a special dividend of Rs. 10) versus Rs. 6 per share in Q3FY2021.

Results

Rs cr

Particulars	Q4FY21	Q4FY20	Q3FY21	y-o-y (%)	q-o-q (%)
Revenue ($ mn)	**2,695.9**	**2,543.4**	**2,616.6**	**6.0**	**3.0**
Net sales	**19,642.0**	**18,590.0**	**19,302.0**	**5.7**	**1.8**
Direct costs	11,740.0	11,151.0	11,195.0	5.3	4.9
Gross profit	**7,902.0**	**7,439.0**	**8,107.0**	**6.2**	**-2.5**
Research & development	335.0	328.0	356.0	2.1	-5.9
SG&A	2,470.0	2,391.0	2,309.0	3.3	7.0
EBITDA	**5,097.0**	**4,720.0**	**5,442.0**	**8.0**	**-6.3**
Depreciation and amortisation	1,117.0	839.0	1,027.0	33.1	8.8
EBIT	**3,980.0**	**3,881.0**	**4,415.0**	**2.6**	**-9.9**
Forex gain/(loss)	47.0	-36.0	2.0	-230.6	2,250.0
Other income	143.0	23.0	124.0	521.7	15.3
PBT	**4,170.0**	**3,868.0**	**4,541.0**	**7.8**	**-8.2**
Tax provision	1,191.0	707.0	544.0	68.5	118.9
Net profit	**2,387.0**	**3,153.0**	**3,981.0**	**-24.3**	**-40.0**
Adjusted net profit	**2,962.0**	**3,153.0**	**3,981.0**	**-6.1**	**-25.6**
EPS (Rs.)	12.0	11.6	14.7	3.0	-18.4
Margin (%)				**BPS**	**BPS**
EBITDA	25.9	25.4	28.2	56	-224
EBIT	20.3	20.9	22.9	-61	-261
NPM	12.2	17.0	20.6	-481	-847

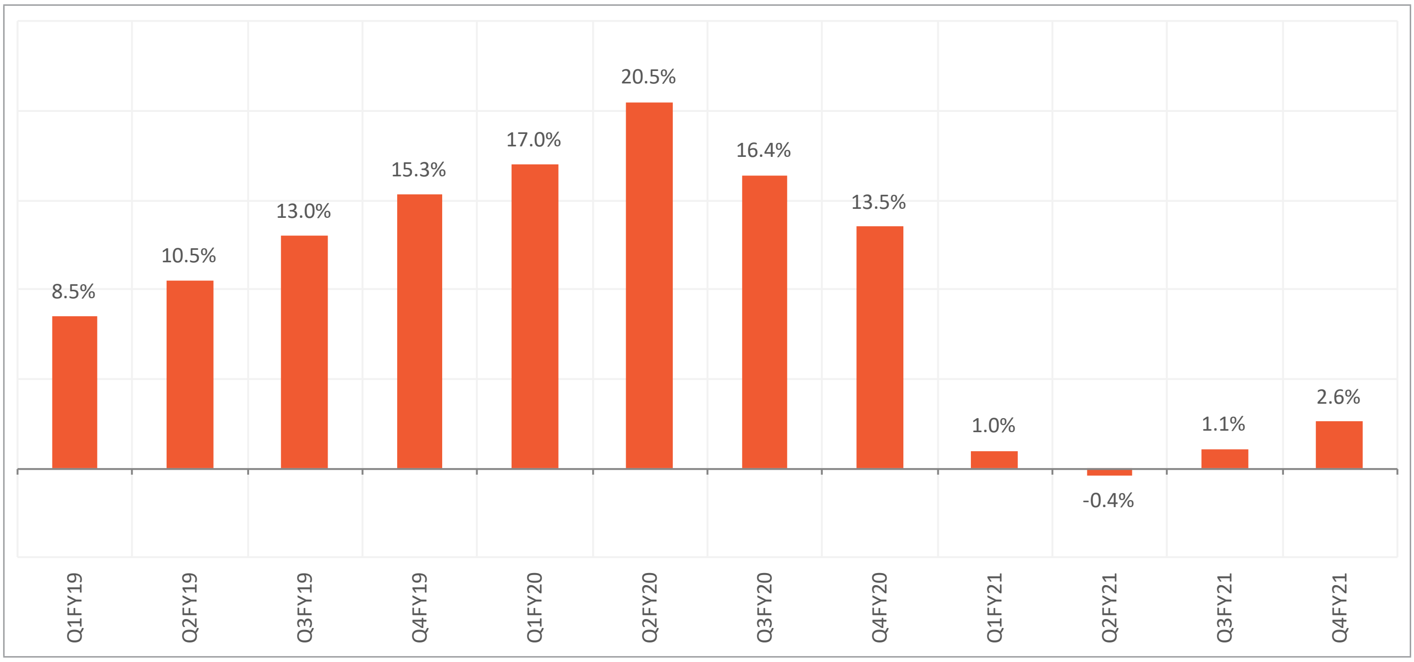
Source: Company; Sharekhan Research

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)	2,696	100	3.0	6.0	2.5	2.6
Geographic mix						
Americas	1,671	62.0	2.2	3.7	2.0	2.9
Europe	785	29.1	1.6	7.5	0.7	-0.3
RoW	240	8.9	14.6	20.9	13.3	11.0
Industry verticals						
Financial services	582	21.6	4.0	8.5	3.3	3.6
Manufacturing	477	17.7	0.8	-9.4	0.3	-12.8
Technology & services	464	17.2	-0.4	12.5	-0.6	11.4
Retail & CPG	272	10.1	-0.9	5.0	-0.9	1.3
Telecommunications, media, publishing & entertainment	218	8.1	0.5	3.4	-0.1	0.5
Lifesciences & healthcare	380	14.1	6.8	19.6	6.6	18.1
Public services	302	11.2	11.0	7.0	9.9	2.2
Service line						
IT and business services	1,938	71.9	5.2	7.9	4.4	3.7
Engineering and R&D Services	407	15.1	0.4	-1.8	0.7	-2.7
Products & platforms	350	13.0	-5.0	5.2	-4.9	3.3
Clients Contribution						
Top 5	356	13.2	0.7	-7.3	0.0	0.0
Top 10	563	20.9	2.5	0.7	0.0	0.0
Top 20	830	30.8	2.7	1.7	0.0	0.0

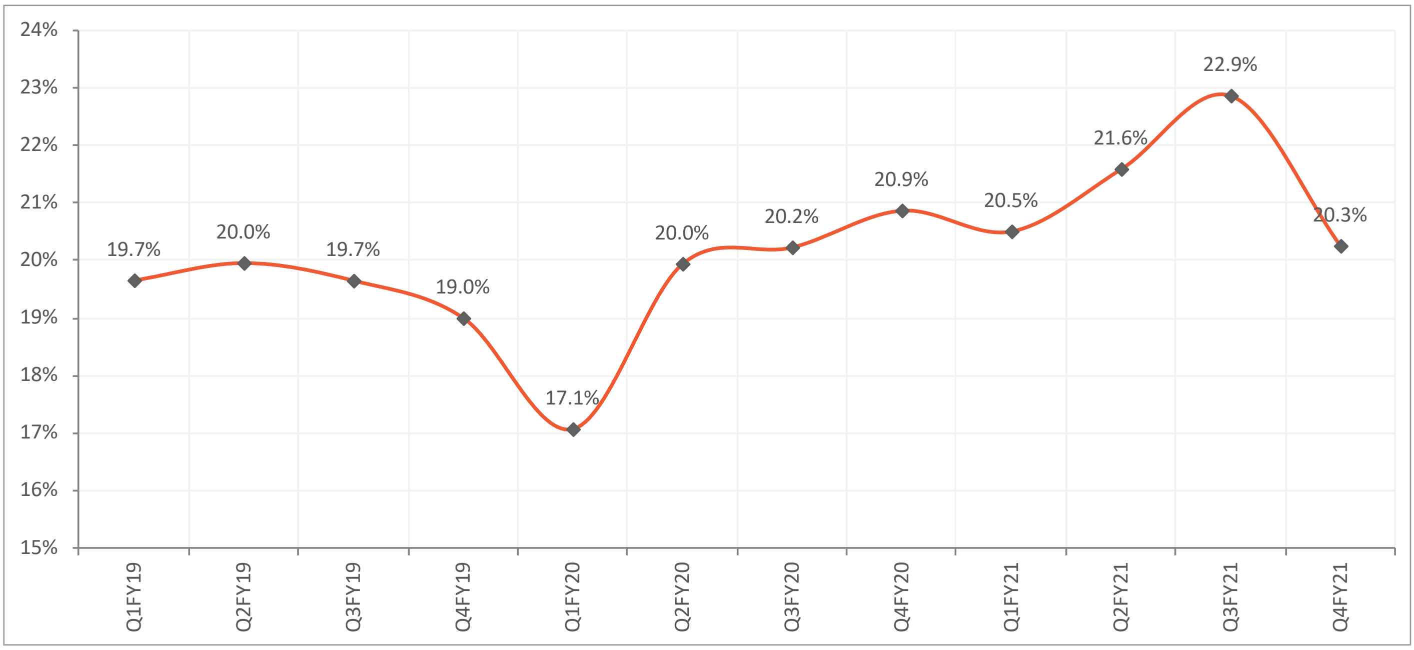
Source: Company; Sharekhan Research

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



Source: Sharekhan Research

EBIT margin contracted owing to wage revision and revenue decline in P&P business



Source: 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 6-9% over CY2021-CY2024E as compared to the 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 migration to Cloud technologies. 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.

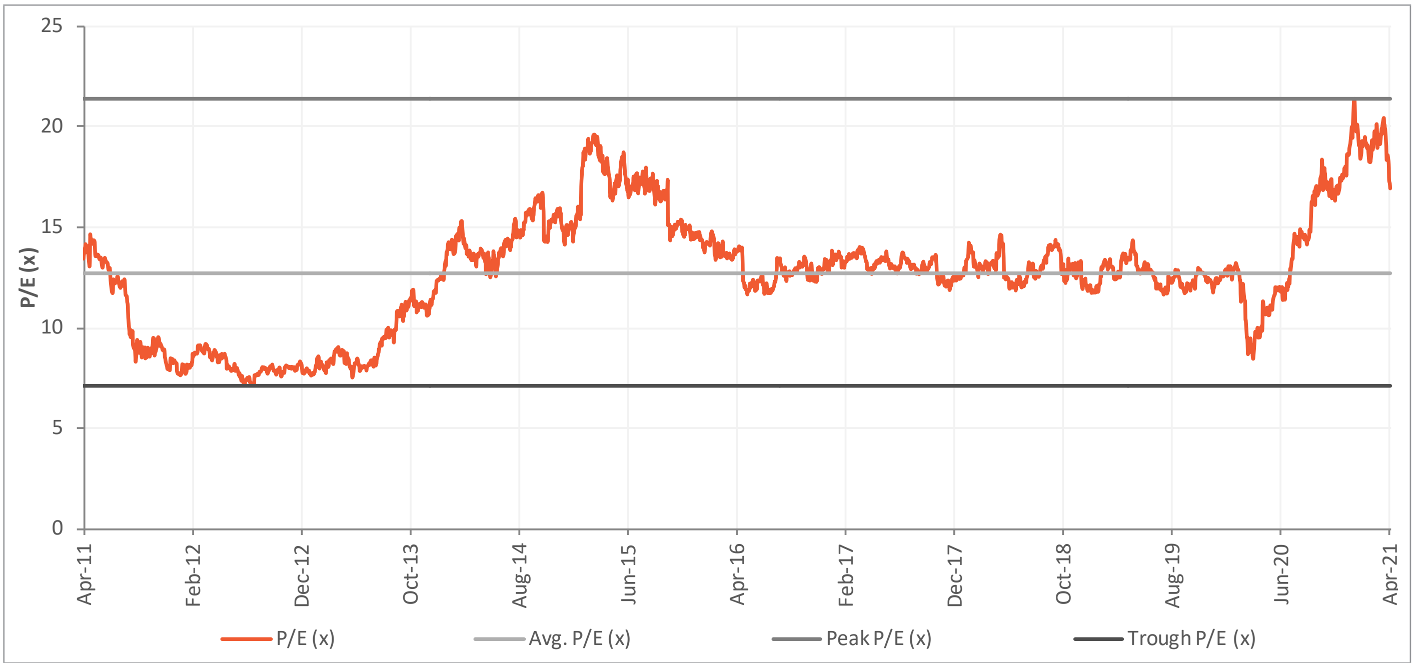
■ **Company outlook – Growth on recovery path**

HCL Technologies has invested aggressively in the fast-growing Mode-2 (a good proxy for digital offering) capabilities, which would help HCL Technologies to 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 a 10-12% penetration of addressable market. 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 a revised PT of Rs. 1200**

We tweaked earnings estimates for FY2022E/FY2023E, to factor in the lag in headline estimates, lower-than-expected EBIT margin guidance, retirement of couple of products and strong deal wins. However, the strong deal bookings, a healthy deal pipeline, strong net employee addition and rising spends on transformation initiatives by clients would help HCL Tech deliver strong revenue growth in FY2022E. With improving free cash flow (FCF) generation, we expect that the management would maintain a higher payout ratio in coming quarters. At CMP, the stock trades at a reasonable valuation of 19x/17x its FY2022E/FY2023E earnings. Hence, we maintain a Buy rating on the stock with a revised PT of Rs. 1,200.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer valuation

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	1,334	426	5,68,308	24.7	21.5	17.2	15.0	3.7	3.5	28.9	31.2
TCS	3,110	370	11,50,331	28.6	25.4	20.4	18.4	11.8	10.4	43.3	43.7
Wipro	476	548	2,60,643	24.9	23.0	16.8	15.8	5.1	4.6	18.2	17.9
HCL Tech	956	271	2,59,372	19.1	16.9	11.7	10.4	3.9	3.5	21.4	21.8

Source: Company, Sharekhan estimates

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 – Engineering and R&D Services
Rahul Singh	President – Financial Services

Source: Company Website

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	SBI Funds Management Pvt Ltd	2.14
2	BlackRock Inc	1.56
3	Artisan Partners LP	1.35
4	Vanguard Group Inc/The	1.31
5	Life Insurance Corp of India	1.24
6	ICICI Prudential Asset Management	1.21
7	Nomura Holdings Inc	0.82
8	Vontobel Holding AG	0.75
9	Virtus Investment Partners Inc	0.62
10	Norges Bank	0.59

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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by BNP PARIBAS

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