Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

HCL Technologies

Eyeing a strong bounceback

IT & ITES	Sharekhan code: HCLTECH	Company 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. 1,168**	
Price Target: **Rs. 1,400**	↑

↑ Upgrade ↔ Maintain ↓ Downgrade

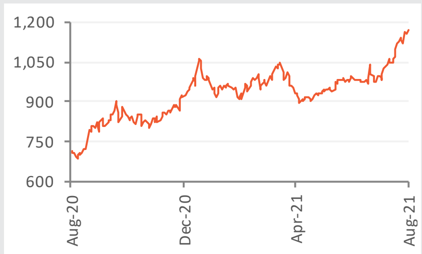
Company details

Market cap:	Rs. 3,16,834 cr
52-week high/low:	Rs. 1,178 / 682
NSE volume: (No of shares)	53.0 lakh
BSE code:	532281
NSE code:	HCLTECH
Free float: (No of shares)	107.6 cr

Shareholding (%)

Promoters	60.3
FII	23.8
DII	11.8
Others	4.1

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	16.8	23.5	28.3	63.8
Relative to Sensex	10.9	13.8	15.8	20.6

Sharekhan Research, Bloomberg

Summary

- After muted performance for the last two consecutive quarters, HCL Tech expects revenue growth to accelerate from Q2FY2022E given higher demand for Cloud IMS, record-high bookings and a strong deal pipeline.
- HCL Tech's ERS business is expected to outperform its IT business in FY2022E led by increasing demand for digital engineering, recovery in asset-heavy industries and deal wins. Company has stepped up investments in products and sales to drive the growth of its P&P business.
- Despite investments in capability building and wage revisions, we expect margins to sustain supported by revenue growth, higher offshoring and employee pyramid.
- We maintain a Buy on the stock with a PT of Rs. 1,400, given anticipation of strong acceleration in revenue growth from Q2FY2022 and reasonable valuation.

HCL Technologies (HCL Tech) differentiates itself for other leading tier-I IT companies given its greater focus towards digital foundation, engineering and R&D services (ERS) and products and platforms (P&P) business and lower exposure to BPO business. HCL Tech has created separate business units for each cloud hyperscaler and recently formed a single global digital business by combining digital consulting, application services, and data analytics services. This would help the company to capture the higher increased demand for digital transformation initiatives and to participate a $300 billion services opportunity in the cloud space. After muted performance for last two consecutive quarters, HCL Tech expects revenue growth to accelerate from Q2FY2022E on the back of higher demand for Cloud IMS and digital foundations, record-high bookings and a strong deal pipeline. The management remains confident of delivering double-digit constant currency (CC) revenue growth in FY2022, translates a 2.8% CQGR over the remaining three quarters. ERS business reported 10.7% y-o-y (up 4.3% q-o-q) revenue growth on CC basis in Q1FY2022 after four consecutive quarters of a y-o-y revenue decline. Though HCL Tech's ERS business revenue has not reverted to pre-COVID levels, the management expects acceleration in revenue growth on the back of increasing demand for digital engineering in both lifescience and healthcare, technology and services verticals, recovery in asset-heavy verticals and good deal wins. The ERS business is expected to deliver better revenue growth compared to IT business in FY2022. As per Zinnov, global ERD spending is expected to grow at 8.6% CAGR to reach $1.9 trillion by 2023, driven by 18.7% CAGR growth of digital engineering over the same period. HCL Tech has stepped up investments in products and sales to drive the growth of its P&P business. Though the P&P business is expected to grow in low single-digits in FY2022, we believe the revenue growth of P&P business would rebound strongly in FY2023. The company plans to hire over 22,000 entry-level staff during FY2022, which indicate strong underlying demand environment and expectation of strong deal momentum going ahead. We expect HCL Tech to deliver industry-matching organic revenue growth over FY2023-FY2024 on the back of robust deal bookings, a healthy deal pipeline, strong growth anticipated in ERS and P&P businesses and broad-based traction across industries. The management believes EBIT margin would improve after two quarters of investments in sales and marketing (S&M) and capabilities. It reiterated its EBIT margin guidance at 19-21% for FY2022.

Our Call

Valuation – Maintain Buy with a PT of Rs. 1,400: HCL Tech remains confident on good pick-up in revenue growth over the next three quarters of FY2022E and acceleration in revenue growth in FY2023E. Despite supply-side challenges, investments in geo expansion and capability building and wage revision, we expect the company would sustain its margin performance on the back of revenue growth, employee pyramids, higher offshoring and expansion into smaller cities. We expect HCL Tech to report USD revenue and earnings growth at a CAGR of 10% and 11% respectively over FY2021-FY2024E. At CMP, the stock trades at a reasonable valuation of 23x/20x/18x its FY2022E/FY2023E/FY2024E earnings, a sharp discount to large peers. With improving free cash flow (FCF) generation, we expect that the management would consider a higher payout ratio in the coming quarters. Hence, we maintain a Buy rating on the stock with a revised PT of Rs. 1,400.

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.

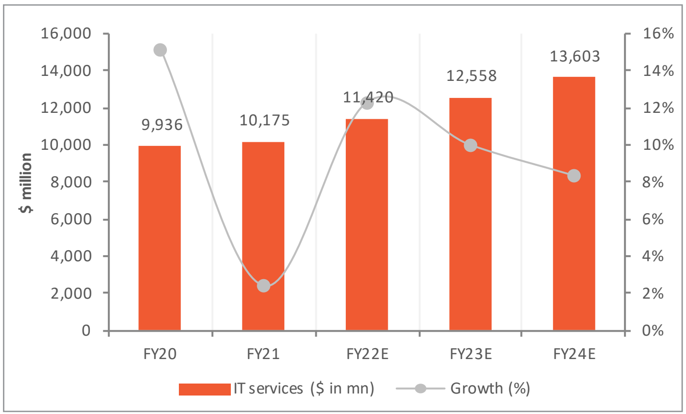
Valuation (Consolidated) Rs cr

Particulars	FY21	FY22E	FY23E	FY24E
Revenue	75,379.0	85,181.0	95,439.4	1,04,744.9
OPM (%)	26.6	24.8	24.6	24.6
Adjusted PAT	13,010.0	13,785.6	15,797.0	17,680.2
% YoY growth	*17.6*	*6.0*	*14.6*	*11.9*
Adjusted EPS (Rs.)	47.9	50.8	58.2	65.2
P/E (x)	24.4	23.0	20.1	17.9
P/B (x)	5.3	4.7	4.3	3.8
EV/EBITDA (x)	15.7	14.9	13.4	12.1
RoNW (%)	23.3	21.7	22.4	22.5
RoCE (%)	25.0	24.4	25.7	26.1

Source: Company; Sharekhan estimates

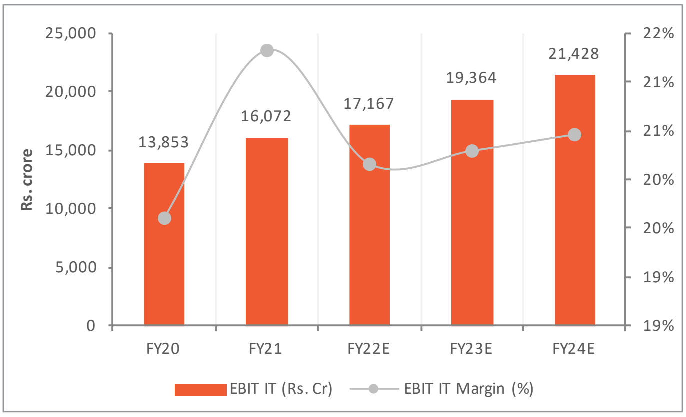
Financials in charts

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



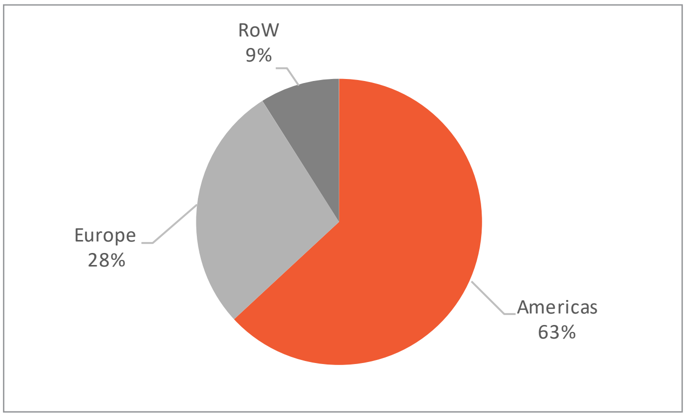
Source: Company, Sharekhan Research

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



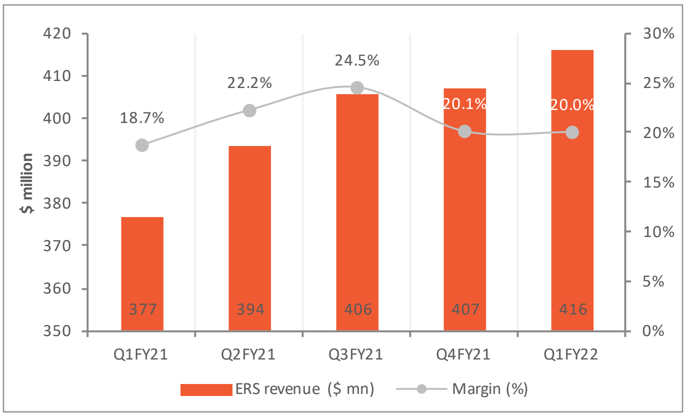
Source: Company, Sharekhan Research

Geograpghy break-up (%)



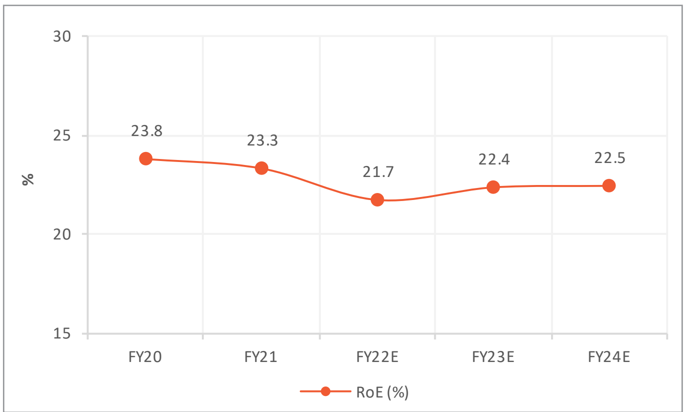
Source: Company, Sharekhan Research

ERS revenue ($ mn) and margin (%)



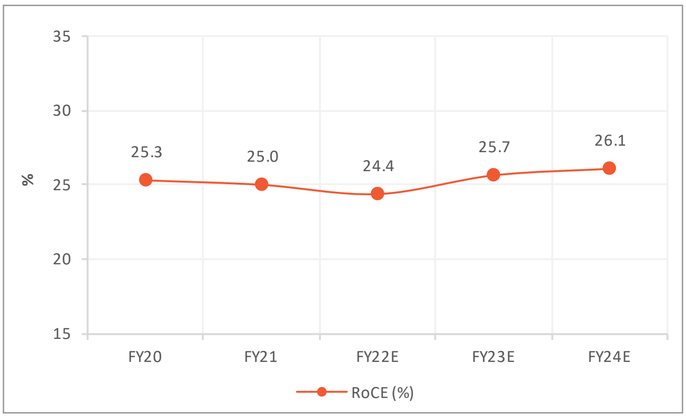
Source: Company, Sharekhan Research

RoE trend (%)



Source: Company, Sharekhan Research

RoCE trend (%)



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector View – Expect acceleration in technology spending going forward

The COVID-19 pandemic is estimated to drag world output by 3.3% in CY2020, as advanced economies see GDP shrink by 4.7%. As a result, global technology spend is estimated to have declined by 3.2% to $1.4 trillion in 2020. Within that, IT services spending is likely to have declined 3.9%, while business process management spends fell by 2.4%. After the initial dislocations led to contractions, the need for business continuity, operational resilience and switch to digital transactions has led to strong demand for IT services. Industry analysts such as Gartner estimate that IT services spending would grow by 7-9% over CY2021-CY2024E as compared to the average of 3.6% achieved over CY2010-CY2020. 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.

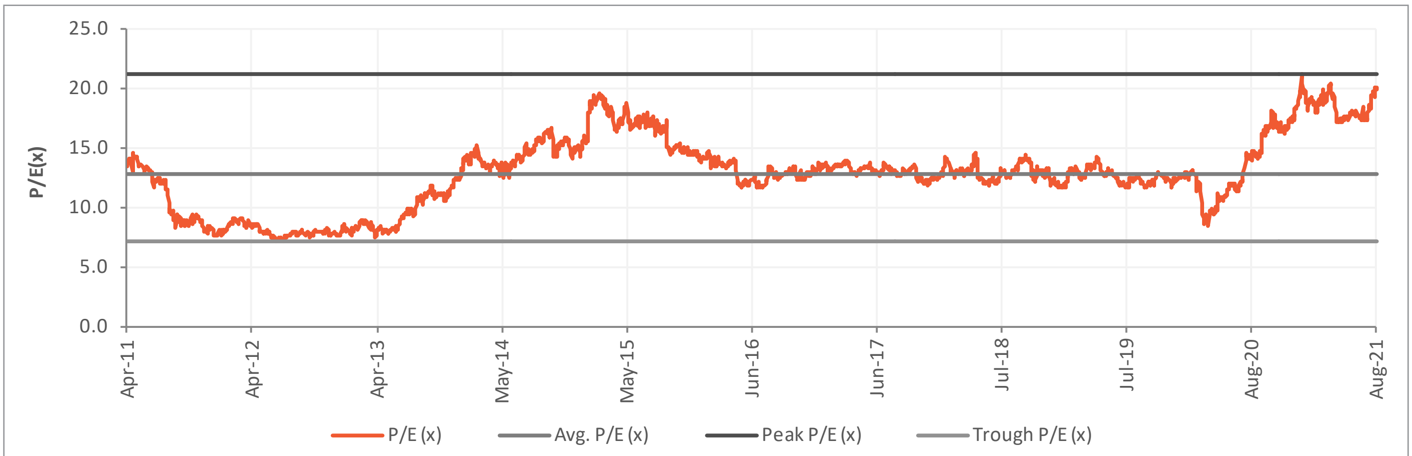
■ Company Outlook – Growth on recovery path

HCL Technologies has invested aggressively in the fast-growing Mode-2 (a good proxy for digital offering) capabilities, which would help it clock strong revenue growth in the coming years. 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 in the 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 PT of Rs. 1,400

HCL Tech remains confident on good pick-up in revenue growth over the next three quarters of FY2022E and acceleration in revenue growth in FY2023E. Despite supply-side challenges, investments in geo expansion and capability building and wage revision, we expect the company would sustain its margin performance on the back of revenue growth, employee pyramids, higher offshoring and expansion into smaller cities. We expect HCL Tech to report USD revenue and earnings growth at a CAGR of 10% and 11% respectively over FY2021-FY2024E. At CMP, the stock trades at a reasonable valuation of 23x/20x/18x its FY2022E/FY2023E/FY2024E earnings, a sharp discount to large peers. With improving free cash flow (FCF) generation, we expect that the management would consider a higher payout ratio in the coming quarters. Hence, we maintain a Buy rating on the stock with a revised PT of Rs. 1,400.

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	1,727	424	7,32,549	32.7	28.1	22.6	19.7	4.9	4.5	27.7	30.0
TCS	3,671	370	13,57,940	34.3	30.2	24.3	21.7	14.0	12.3	42.6	43.4
HCL Tech	1,168	271	3,16,834	23.0	20.1	14.9	13.4	4.7	4.3	21.7	22.4

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	2.17
2	Life Insurance Corp of India	1.94
3	Artisan Partners LP	1.79
4	BlackRock Inc	1.62
5	ICICI Prudential Asset Management	1.52
6	Vanguard Group Inc/The	1.29
7	Vontobel Holding AG	0.82
8	Nomura Holdings Inc	0.71
9	Norges Bank	0.59
10	Virtus Investment Partners Inc	0.59

Source: Bloomberg (Old data)

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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