Stock Update

Event Update

Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

HCL Technologies Ltd

Capitalising on right opportunities

IT & ITeS	Sharekhan code: HCLTECH
Reco/View: Buy ↔	CMP: Rs. 1,059	Price Target: Rs. 1,400 ↔

↑ Upgrade ↔ Maintain ↓ Downgrade

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 13.21

Updated 0Apr8, 2022

Low Risk

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

Source: Morningstar

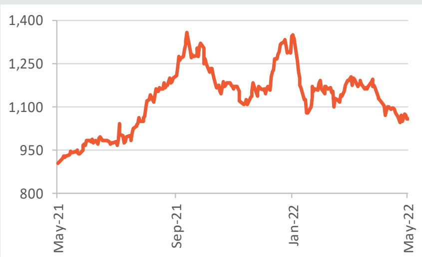
Company details

Market cap:	Rs. 2,87,282 cr
52-week high/low:	Rs. 1,377 / 895
NSE volume: (No of shares)	47.8 lakh
BSE code:	532281
NSE code:	HCLTECH
Free float: (No of shares)	107.6 cr

Shareholding (%)

Promoters	60.7
FII	19.5
DII	15.1
Others	4.6

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-6.4	-9.1	-8.8	16.8
Relative to Sensex	3.2	-0.1	2.8	8.1

Sharekhan Research, Bloomberg

Summary

- HCL Tech's Investor day 2022 put the spotlight on emerging demand drivers, higher digital revenue mix, investments in new markets, and power of partner ecosystem. P&P business is on track to deliver 18% IRR, above business hurdle rate of 12-15% post tax IRR in USD terms.
- The company is well-positioned to capture incremental market opportunities and win large integrated deals given its strong capabilities across digital businesses, differentiated challenger in service lines, and strong client mining.
- Margins would stay stressed in the medium term owing to return of discretionary spends, transition costs of large deals and higher wage revision. Improved pricing and fresher hires are key margin levers in FY2023E.
- We maintain a Buy on HCL Technologies with an unchanged of Rs. 1400, given strong digital capabilities, healthy order intake, increasing payout and reasonable valuation.

We attended HCL Technologies' (HCL Tech's) investor day 2022, wherein management highlighted on demand drivers, change in revenue mix in-line with client's spending pattern, benefits from investments in new frontier markets, power of partner ecosystem, and transformation of products and platform (P&P) business. The company has strengthened its relationships with clients over the past few years, given its unique service and product offerings such as cloud, digital, engineering, and products. HCL Tech remains confident of delivering strong organic revenue growth in its IT services business, given its strong competencies across its digital businesses, good client mining, harnessing the power of multi-way partnering, and cross-sell opportunities. The company has already recovered around 68% of the investments in P&P business and plans to recover the balance investments in the next 2-3 years.

- **Demand drivers to lead growth:** The demand environment continues to remain strong on account of higher digital transformation initiatives by global enterprises. The shift from legacy to scale digitalisation programmes/cloud transformation initiatives is creating large opportunities for Indian IT. Further, demand for digital talents and higher global sourcing of the ERS business are key drivers of higher outsourcing from India. We believe HCL Tech is well positioned to capture incremental market opportunities, given its strong capabilities across digital businesses, diffentiated challenger in service lines, strong partner ecosystem, and strong client mining.
- **Well poised to maintain growth momentum in both traditional engineering and digital engineering:** Digital engineering contributes around 30% of the global ERS spends, which is growing at a faster rate compared to traditional engineering services. The company's traditional engineering revenue grew by 11% y-o-y in FY2022 despite lower revenue share, while digital engineering reported strong revenue growth of 34% y-o-y. The company's services in the ERS segment are softwarisation, industry 4.0, 5G services, silicon platform services, data engineering, and AI. As the company caters to 61 out of these top 100 R&D spenders, we believe the company has significant headroom for the growth going ahead.
- **Margins to stay under pressure in the near term:** Supply-side challenges, investments in frontline sales and building capabilities, return of discretionary spends, transition costs of large deals, and higher wage revision would continue to put pressure on margin of services business in the near term. Improved pricing and fresher hiring are key margin levers in FY2023E. Further, utilisation, offshoring, automation, better productivity, and new offshore/nearshore locations are margin levers for FY2023E. The company has maintained its EBIT margin guidance band of 18%-20% for FY2023.

Our Call

Valuation – Maintain Buy with an unchanged PT of Rs. 1,400: The company's strength in digital foundation, unique integrated infra and app services, strong deal intake, and leadership in the fast-growing ERD segment would help HCL Tech to accelerate its service revenue growth in FY2023E. At the CMP, the stock trades at a reasonable valuation of 19x/17x its FY2023E/FY2024E earnings. We continue to prefer HCL Tech, given strong capabilities in digital foundation, rising payout ratio, higher return ratios, and strong cash conversion. Hence, we maintain Buy on the stock with a price target (PT) of Rs. 1,400.

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	FY22	FY23E	FY24E	FY25E
Revenue	85,651.0	98,346.6	1,11,640.0	1,24,800.3
OPM (%)	24.0	23.2	23.8	24.0
Adjusted PAT	13,499.0	15,861.0	18,502.6	20,823.0
% YoY growth	*4.3*	*17.5*	*16.7*	*12.5*
Adjusted EPS (Rs.)	49.7	54.9	64.1	72.1
P/E (x)	21.3	19.3	16.5	14.7
P/B (x)	4.6	4.3	4.0	3.8
EV/EBITDA (x)	14.6	13.3	11.4	10.1
RoNW (%)	22.1	24.6	26.8	28.1
RoCE (%)	23.7	26.6	29.2	30.9

Source: Company; Sharekhan estimates

We attended HCL Tech's investor day 2022, wherein management highlighted on growth priorities, demand drivers, unique service lines, pyramid rationalisation, selective in strategic partner for clients and expansion in geographies, power of partner ecosystem, integrated solutions, and higher dividend payout. Further, demand environment continues to remain strong on account of acceleration in digital-transformation initiatives by the customers. However, supply-side issues continue to be a concern for the company. Hence, the company continues to invest on talents to cool off supply-side challenges. North Asia, Central America, Africa, and Eastern Europe are newer delivery geographies for the company. The company has strengthened its relationships with clients over the past few years, given its unique service and product offerings such as cloud, digital, engineering, and products. The company has a leadership position in three segments (engineering, infrastructure, and products) in the industry.

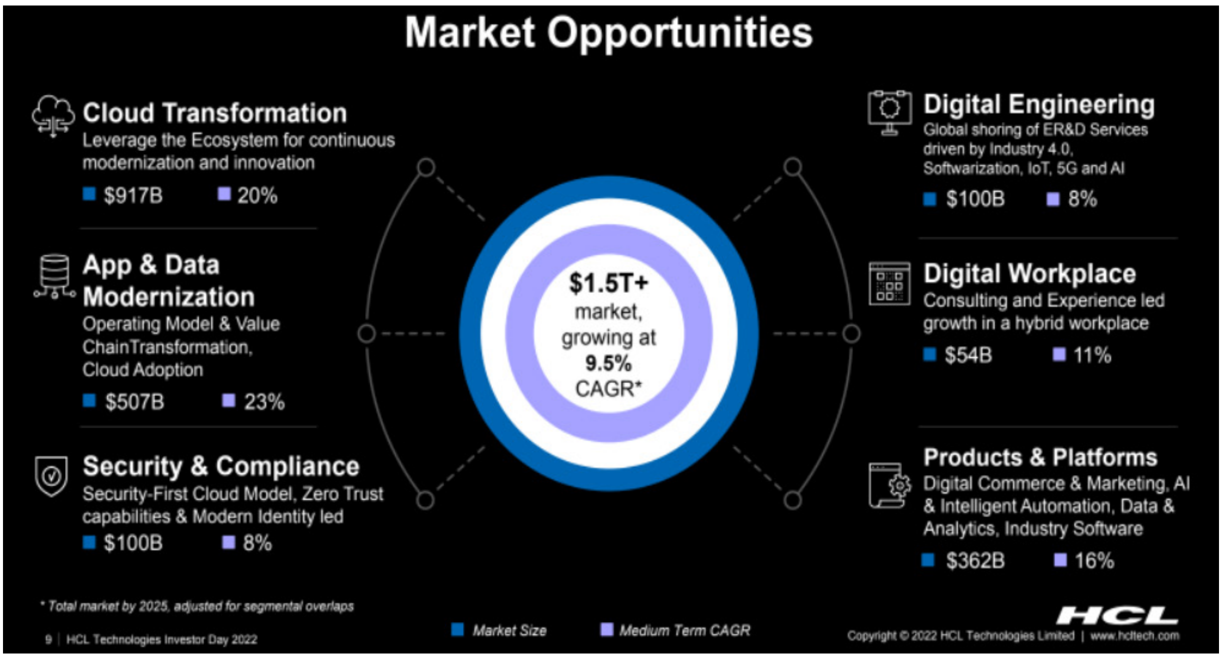
Key strategic objectives to create growth avenues

The company highlighted five key strategic objectives – (1) leadership in differentiated services and products – HCL Tech is the pioneer in three of the five global technological service segments. The company continuously focuses on innovating service portfolio and products. As Cloud is the biggest demand driver in the market, the company's integrated services, integrated solutions, partnership ecosystem, solution accelerators, and automation differentiate the company from its global peers and (2) employer of choice in professional services across selected geographies. Less than 1% attrition among the top 30 leaders in the past three years indicates leadership stability; and (3) preferred digital partner for global 2,000 enterprises in chosen markets. Around 70% of tech spends ($1.5 trillion) are being done by these G2000 enterprises in selected countries and the company has identified 15 countries, which make 85% of the total tech spends; (4) weave ESG goals into business strategy; and (5) create value for shareholders in the medium term through strong organic growth, efficient capital allocation, and improved profitability.

Emerging demand drivers to drive its growth going ahead

The demand environment continues to remain strong because of higher digital-transformation initiatives by global enterprises. The shift from legacy to scale digitalisation programme/cloud transformation initiatives is creating large opportunities for Indian IT services companies. Increasing demand for digital talents and higher global sourcing of the ERS business are key drivers of higher outsourcing from India. HCL Tech remains confident in delivering strong organic revenue growth in its IT services business and capture incremental market share given strong capabilities across digital businesses (digital business, digital foundation, digital operations, and digital engineering), unique position in application and data modernisation space, focus on client mining, new frontier markets, strong partner ecosystem, and cross-sell opportunities.

HCL Tech is well positioned to capture market opportunities



Source: company

Digital business contribution improving; Focus on selective large accounts

The company's digital share (include Mode-2 services, digital engineering, consulting, and experience business) of services increased to 34.5% in FY2022 from 18.2% in FY2019. Digital engineering contributes around 30% of its ERS business revenue. Further, the pandemic has accelerated growth of consulting and experience business within digital foundation services. Over the past 10 years, infrastructure and ERS business revenue were adding maximum incremental revenue every year. With investments in Mode 2 business for the past few years, the company witnessed incremental revenue contribution from its application services business. Strong growth in the digital foundation business and digital engineering business helped the company to take care of lower growth of its core business. Further, the company started focusing on large accounts, where tech spends remain robust. The company's focus on strong client mining, partner ecosystem, and building strong digital capabilities helped it to align the areas where tech spends have accelerated over the past few years. Hence, the company aims to outpace its large peers in terms of organic revenue growth. The company has maintained its revenue growth guidance of 12-14% for FY2023.

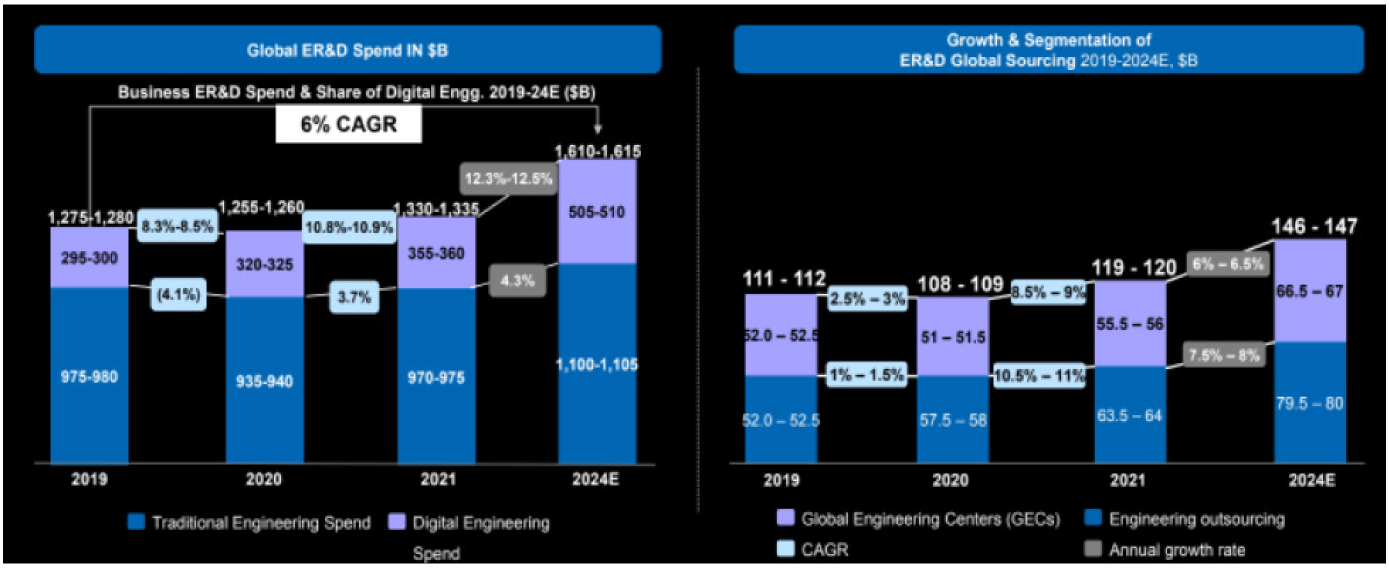
Digital business services growth to stay strong

HCL Tech's digital business services comprise consulting, application services, and data analytics, which contributed 50% to incremental growth in FY2022. HCL Tech has strong differentiated capabilities in transformation and integration of application and infrastructure services. Since 2020, the company has seen 54+ renewals from existing customers in both Mode-1 and Mode-2 businesses with enhanced scope for digital transformation and 66+ new customer wins as digital challenger with integrated solution areas (infra+apps) given its strong understanding on the complete stack. Enterprise data market place has a potential of $600 billion-700 billion of market opportunity. We believe HCL Tech is well placed to derive benefit from increased cloud adoption, higher digital adoption across verticals, and operating model transformation.

Well poised to capture market share in the traditional engineering and digital engineering space

Digital engineering contributes around 30% to the global ERS spends, which is growing at a faster rate compared to traditional engineering services. The top 100 R&D spenders' spend is around 54% of the total market share. As the company caters to 61 out of these top 100 R&D spenders, we believe it has significant headroom for growth going ahead. Further, the pandemic has increased the share of outsource spending and is expected to reach $80 billion by 2024. The company's traditional engineering revenue grew by 11% y-o-y (higher than traditional engineering spend growth rate of 3-4%) in FY2022 despite lower revenue share, while digital engineering reported strong revenue growth of 34% y-o-y. Except auto sub-segment, the company's ERS revenue growth across verticals/sub-segments remained ahead of the respective industry vertical's growth rate. HCL Tech believes it would start reporting leading growth in the auto sub-segment once the industry's capabilities shift towards CASE based. The company's key strategic bets such as digital engineering, high-growth verticals, and high potential geographies will drive its ERS business growth going ahead. The company's services in the ERS segments are softwarisation (47 out of the top R&D spenders), industry 4.0 (34 out of the top R&D spenders), 5G services (13 out of the top R&D spenders), silicon platform services (8 out of the top R&D spenders), data engineering and AI (27 out of the top R&D spenders). We believe the company is well poised to grab opportunities from both traditional and digital engineering space, given higher outsourcing and strong relationship with R&D spenders.

Digital engineering to grow at a faster rate

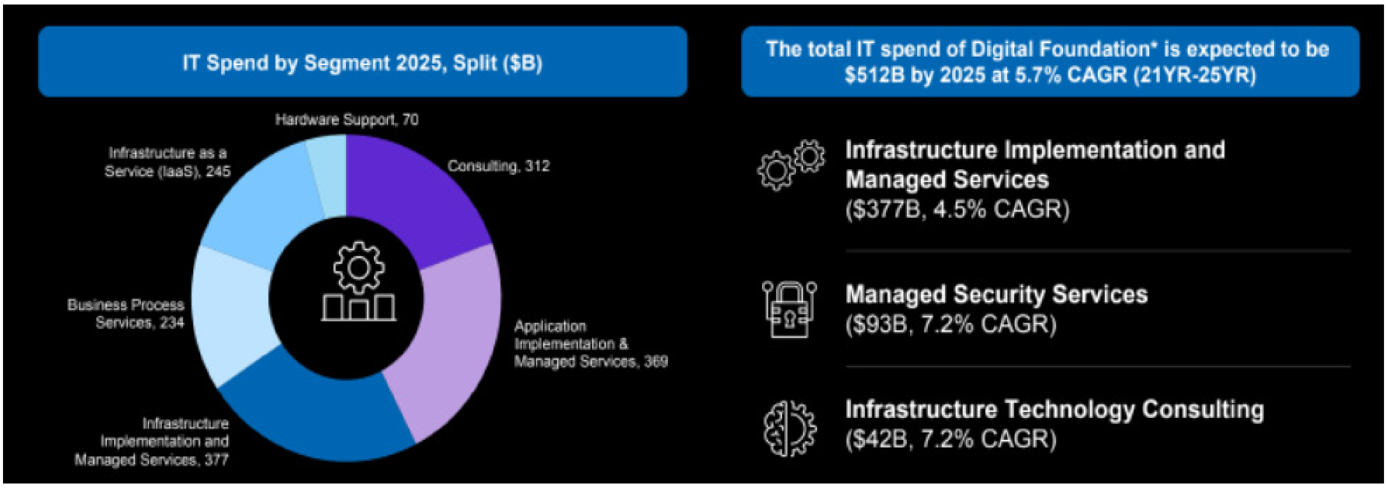


Source: company

Digital foundation business in on strong footing

Digital foundation is the largest IT spend segment for HCL Tech. The total IT spend of Digital Foundation is expected to post a 5.7% CAGR to $512 billion over FY2021-FY2025E. The major growth trend in this digital foundation remains infrastructure technology consulting, managed services for cloud, managed security services, and infrastructure implementation and managed services. The company grew 2x of market growth in the past three years, while it aspires to grow 2x-3x of market growth in the next 3-4 years. Management cited that 40% of G-100 clients are HCL Tech's digital foundation clients. Growth of digital foundation will be driven by (1) expansion in existing clients, (2) potential growth in focused countries and new frontiers, (3) potential market first-time outsourcers, (4) higher addressable renewal opportunities, (5) strong partnerships with Hyperscalers and technology providers, and (6) focusing on next-gen operating models in hybrid cloud, experience, and security.

Digital foundation spends



Source: company

P&P business – Taking measures to be back on growth

The company entered into the product and platform business with an intention of market permission (to become a credible enterprise software player) and market access to a large global customer base and sales channel. In its P&P business, the company has an access to 6,800 global customers with $10K+ relationship, which include 66 Fortune 100, 223 Fortune 500, and 241 global 500 clients. The company's P&P segment caters to four key markets, which have cumulatively more than $90 billion market opportunity. The company has shifted to integrated P&P portfolio (combining related products into seven solutions) with the focus of aligning them to selected markets. These P&P portfolio provides cross-selling and up-selling opportunities to the company. Management expects margins for the P&P business to improve from current levels in FY2023. The company's P&P business is progressing well to deliver IRR of 18% in USD terms after tax. The company has made aggregate investment of $3.5 billion in P&P business though the acquisitions and IP deal, since 2020. The company has already recovered around 68% of the investments in P&P business and plans to recover the balance investments in the next 2-3 years.

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.

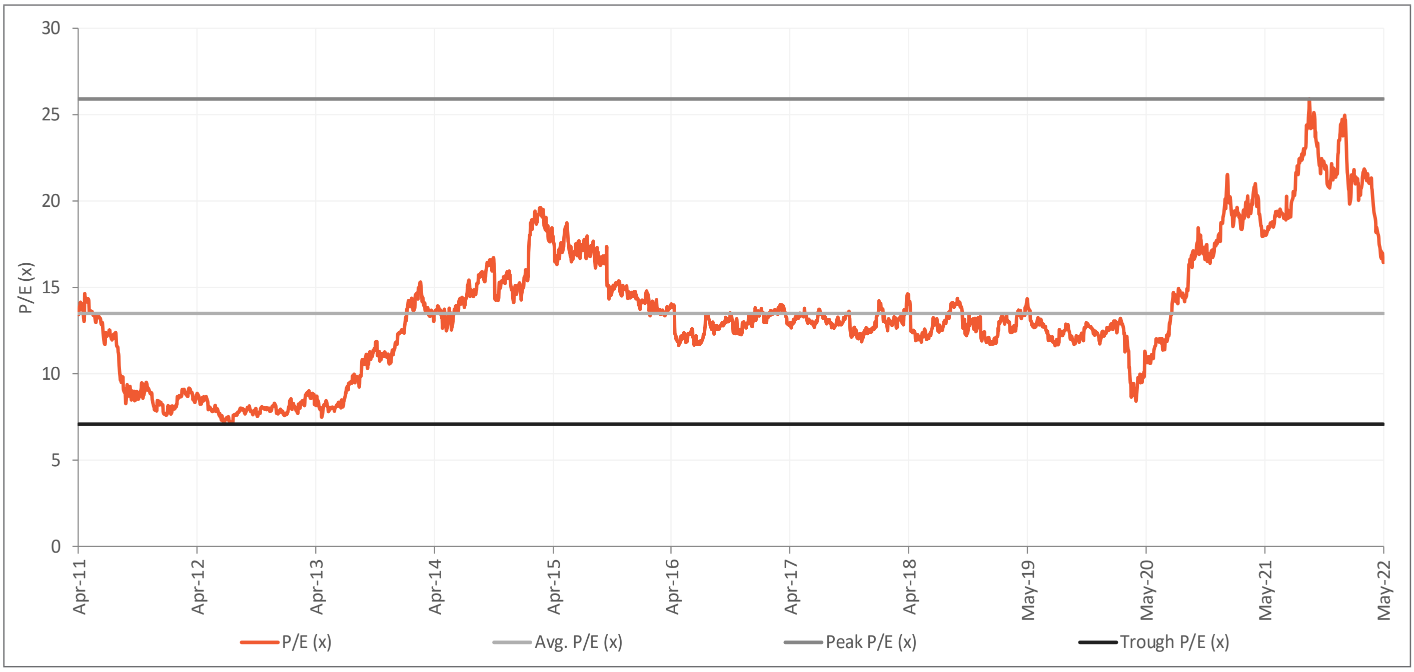
■ Company outlook – Leveraging on core strengths

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 modernisation make it a strong contender for building out digital-transformation initiatives for clients.

■ Valuation – Maintain Buy with a PT of Rs. 1,400

The company's strength in digital foundation, unique integrated infra and app services, strong deal intake, and leadership in the fast-growing ERD segment would help HCL Tech to accelerate its service revenue growth in FY2023E. At the CMP, the stock trades at a reasonable valuation of 19x/17x its FY2023E/FY2024E earnings. We continue to prefer HCL Tech, given strong capabilities in digital foundation, rising payout ratio, higher return ratios, and strong cash conversion. Hence, we maintain Buy on the stock with a PT of Rs. 1,400.

One-year forward P/E (x) band



Source: 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 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 and Chairman
C Vijay Kumar	Managing Director and 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

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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