Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

Stock Update

Result Update

HCL Technologies Ltd

Mixed bag Q1; Guidance maintained

IT & ITES	Sharekhan code: HCLTECH
Reco/View: Buy ↔	CMP: Rs. 928 | Price Target: Rs. 1,140 ↓

↑ 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 July 08, 2022

Low Risk

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

Source: Morningstar

Company details

Market cap:	Rs. 251,842 cr
52-week high/low:	Rs. 1,377 / 925
NSE volume: (No of shares)	36.5 lakh
BSE code:	532281
NSE code:	HCLTECH
Free float: (No of shares)	106.6 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	-18.0	-28.0	-5.2
Relative to Sensex	-8.3	-10.0	-17.2	-8.1

Sharekhan Research, Bloomberg

Summary

- Q1FY2023 revenue growth was in line with expectations with steady progression of clients across higher size buckets. Margins missed estimates owing to supply-side pressures. Cash generation, net staff addition and attrition rate remained weak.
- The management reiterated its revenue growth guidance of 12-14% on CC terms, in line with our expectations, and 18-20% for EBIT margin for FY2023 despite supply side pressures, and delay in hike in realisations.
- HCL Tech is expected to achieve its revenue growth guidance in FY2023E given its strength in digital foundation, unique integrated infrastructure and app services, and presence in the fast-growing ERD segment.
- We maintain a Buy on HCL Technologies with a revised PT of Rs. 1,140, given strong growth in application services, good dividend payout, healthy order intake and reasonable valuation.

HCL Tech delivered in-line revenue growth with steady progression of clients across higher size buckets and healthy deal wins, while EBIT margin remained below expectations owing to supply-side pressures, delay in hike in realizations and rising travel expenses. Headline constant currency (CC) revenue growth of 2.7%/15.6% q-o-q/y-o-y was in line with our estimates. HCL Tech's services business (IT business + ERD) revenue growth was moderated to 2.3% q-o-q in Q1FY2023 after reporting more than 5% q-o-q CC growth for last three consecutive quarters. EBIT margins declined 100 bps to 17%. The management believes that strong demand momentum would continue in the near-term because of higher enterprise spending on digital transformation, IT operating model transformation, and consulting offerings. HCL Tech's strength in digital foundation and modern applications position the company to capture a reasonable share of the market opportunity. Hence, the company reiterated its 12-14% revenue growth guidance for FY2023E, in-line with our expectations and an EBIT margin of 18-20% despite reporting a 17% EBIT margin in Q1FY2023. The company is expected to achieve lower end of EBIT margin guidance given innovative pricing, optimisation of operating costs, pyramid rationalization, fresher addition and higher utilisation.

Key positives

- Engineering & R&D (ERD) segment grew strongly at 23% y-o-y on CC
- P&P business growth recovered to 5.1% q-o-q
- Steady addition of clients across larger buckets

Key negatives

- EBIT margin declined by 100 bps q-o-q to 17.0%, below than expectations
- Attrition inched up by 190 bps q-o-q to 23.8%
- Weak cash flow generation

Management Commentary

- Company retained 12-14% revenue growth guidance in CC terms and an 18-20% EBIT margin band
- The company does not see any slowdown in demand in the near term, though it indicated some change in demand pattern. Further, it cited that deal pipeline remains at record-high.
- Nearly 30,000 freshers would be added in FY2023E. Of which, 10,000 would be recruited in Q2
- Pricing discussion has started with selected customers. Clients are open to discuss on pricing given higher wage inflation

Revision in estimates – We cut our earnings estimates for FY2023E/FY2024E/FY2025E by 2-7% factoring in Q1FY2023 results, contraction in operating profitability and anticipated slowdown in tech spends owing to adverse macro headwinds.

Our Call

Valuation – Maintain Buy with a revised PT of Rs. 1,140: HCL Tech is expected to achieve its revenue growth guidance in FY2023E given its strength in digital foundation, unique integrated infrastructure and app services, and leadership in the fast-growing ERD segment. At the CMP, the stock trades at a reasonable valuation of 17x/16x its FY2023E/FY2024E earnings, in-line with its 5-year average valuation. Any further weakness in stock price would turn the risk-reward ratio more favorable. Further, the stock price offers dividend yield of 4.5% at current market price. We continue prefer HCL Tech, given strong capabilities in digital foundation, higher payout ratio, and healthy deal wins. Hence, we maintain Buy on the stock with a price target (PT) of Rs. 1,140.

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	98,958.0	1,07,707.6	1,19,172.4
OPM (%)	24.0	22.1	22.6	22.9
Adjusted PAT	13,499.0	14,144.6	15,698.2	17,663.3
% YoY growth	*4.3*	*4.8*	*11.0*	*12.5*
Adjusted EPS (Rs.)	49.7	53.9	59.8	67.3
P/E (x)	18.7	17.2	15.5	13.8
P/B (x)	4.1	3.8	3.6	3.4
EV/EBITDA (x)	11.5	11.1	10.0	8.9
RoNW (%)	22.1	22.1	23.0	24.4
RoCE (%)	23.7	25.2	26.5	28.3

Source: Company; Sharekhan estimates

In-line revenue, margin tad below estimates; weak cash conversion

HCL Tech delivered in-line revenue growth with steady progression of clients across higher size buckets and healthy deal wins. Headline constant currency (CC) revenue growth of 2.7%/15.6% q-o-q/y-o-y was in line with our estimates. Revenue growth was led by strong 3.7% q-o-q CC growth in engineering & R&D (ERD) business and 5.1% q-o-q on CC growth in the product & platform (P&P) business. Whereas, IT and business services business revenue growth moderated to 2% q-o-q on CC terms. As a result, the company's services business (IT business + ERD) revenue growth was moderated to 2.3% q-o-q in Q1FY2023 after reporting more than 5% q-o-q CC growth for last three consecutive quarters. On a reported basis, USD revenue grew by 1.1%/11.2% q-o-q/y-o-y to $3,024.9 million. EBIT margins declined 100 bps to 17%, a tad below our estimates, owing to a contraction of margins in the services business, elevated subcontractor expenses (-100bps q-o-q), higher retention expenses (-50 bps q-o-q), and higher travel and visa expenses (+35bps q-o-q), which was partially offset by margin improvement in the P&P business, operationally efficiency and currency tailwind (+40bps). Net profit of Rs. 3,283 crore (down 8.7% q-o-q, but up by 2.1% y-o-y) was marginally above our estimates led by higher net other income. Cash conversion in terms of free cash flows (FCF) to net profit and FCF to EBITDA ratios declined q-o-q to 39% and 26%, respectively from 144% and 103%, respectively in Q4FY2022.

Near-term demand outlook intact, retained guidance

The management indicated that it does not see any slowdown in demand environment despite deteriorating macro environment. It continues to see strong demand momentum because of higher spending by enterprises on digital transformation, IT operating model transformation and consulting offering. The company's services business segment would maintain its growth momentum in the near-term, led by leadership in engineering business, digital application business and cloud transformation initiatives across the verticals. HCL Tech signed 16 new deals with TCVs of $2 billion during the quarter, which is in-line lower end of guidance. In addition, the company's ACVs grew by 17.9% y-o-y, which provides growth visibility for the near term. Strong client addition continued across large revenue categories as the company added 1, 9 and 10 clients sequentially in $100 million, $20 million and $10 million revenue category. 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. Hence, the company reiterated its 12-14% revenue growth guidance in FY2023E.

Expect HCL to achieve lower end of EBIT margin guidance

The management maintained its EBIT margin guidance band 18-20% for FY2023 despite posting EBIT margin of 17% in Q1FY2023. Note that the company had slashed its EBIT margin guidance to 18-20% for FY2023 from 19-21% in FY2022, owing to supply-side pressures, investments in building capabilities and rising retention expenses. The management remains optimistic on achieving the lower end of EBIT margin guidance given margin levers such as innovative pricing, optimisation of operating costs, pyramid rationalization, fresher addition and higher utilization. We expect that the company's EBIT margin would improve sequentially in Q2FY2023 and Q3FY2023 aided by cost efficiencies, while EBIT margin is expected to decline sequentially in Q4FY2023 given was seasonality.

Q1FY2023 Key earnings call highlights

- **Product revenues recover:** HCL Tech's P&P business revenue grew by 5.1% q-o-q on a CC basis. Enterprises are making consolidated digital platform investments, which would benefit HCL's software business. The P&P business consists of three revenue streams – (1) Subscriber and support revenue), (2) professional service and (3) Product license sales.
- **Price increase to take time:** HCL Tech stated that price hikes would still take time, it is approaching discussions with clients on a selected basis. Management highlighted that most of its customers are considerate in giving additional pricing given wage inflation.
- **Fresher intake to continue:** The company plans to hire around 30,000 freshers in FY2023, of which 10,000 would be hired in Q2FY2023E.
- **Net headcount addition moderated:** Headcount increased by a net 2,089 on a sequential basis to 210,996, which is the lowest since Q2FY2021.
- **Strong client additions:** The number of clients in $100 million and $20 million revenue bucket improved on sequential and y-o-y basis.   DSO decreased by 3 days sequentially.
- **Dividend payout:** HCL Tech announced a payout policy that entails investor payouts of not less than 75% of net income cumulatively over five years FY2022 to FY2026E. The company announced a dividend of Rs. 10 per share for the quarter. The stock offers a good dividend yield of 4.3% at the current market price.
- **Weak cash generation:** Free cash flow (FCF) stood at $166 million (vs $685 million in Q4FY22) with FCF to net income ratio at 39% (vs 144% in Q4FY22). Net cash stood at $1,762million versus $2,388 million in Q4FY2022.

Results Rs cr

Particulars	Q1FY23	Q1FY22	Q4FY22	y-o-y (%)	q-o-q (%)
Revenue ($ mn)	**3,024.9**	**2,719.6**	**2,993.1**	**11.2**	**1.1**
Net sales	**23,464.0**	**20,068.0**	**22,597.0**	**16.9**	**3.8**
Direct costs	15,066.0	12,197.0	14,292.0	23.5	5.4
Gross profit	**8,398.0**	**7,871.0**	**8,305.0**	**6.7**	**1.1**
Research & development	391.0	396.0	380.0	-1.3	2.9
SG&A	3,032.0	2,567.0	2,872.0	18.1	5.6
EBITDA	**4,975.0**	**4,908.0**	**5,053.0**	**1.4**	**-1.5**
Depreciation and amortisation	983.0	977.0	984.0	0.6	-0.1
EBIT	3,992.0	3,931.0	4,069.0	1.6	-1.9
Forex gain/(loss)	82.0	41.0	135.0	100.0	-39.3
Other income	263.0	153.0	117.0	71.9	124.8
PBT	**4,337.0**	**4,125.0**	**4,321.0**	**5.1**	**0.4**
Tax provision	1,056.0	894.0	721.0	18.1	46.5
Adjusted net profit	**3,283.0**	**3,214.0**	**3,594.0**	**2.1**	**-8.7**
EPS (Rs.)	12.5	12.3	12.4	2.2	0.6
Margin (%)				**BPS**	**BPS**
EBITDA	21.2	24.5	22.4	-325	-116
EBIT	17.0	19.6	18.0	-258	-99
NPM	14.0	16.0	15.9	-202	-191
Tax rate	24.3	21.7	16.7	268	766

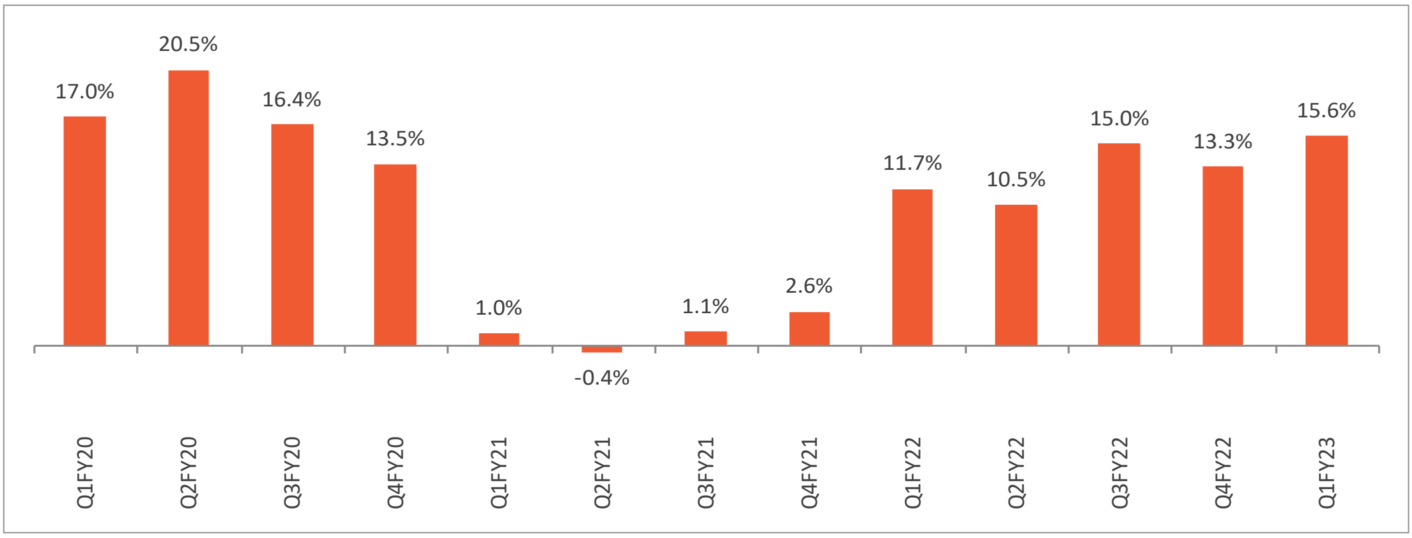
Source: Company, Sharekhan Research

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)	3,025	100	1.1	11.2	2.7	15.6
Geographic mix						
Americas	1,942	64.2	3.3	13.2	2.8	17.5
Europe	841	27.8	-0.7	10.8	1.6	22.5
RoW	242	8.0	-9.2	-1.1	1.1	18.2
Industry verticals						
Financial services	638	21.1	2.0	6.2	0.8	16.4
Manufacturing	554	18.3	2.7	18.3	-0.5	19.1
Technology & services	466	15.4	-11.1	-1.0	10.9	34.2
Retail & CPG	284	9.4	1.1	4.6	-1.4	5.8
Telecommunications, media,	x	x	x	x	x	x
publishing & entertainment	278	9.2	8.1	29.5	4.3	29.2
Lifesciences & healthcare	496	16.4	11.2	24.1	2.7	15.7
Public services	309	10.2	-3.7	5.0	-0.2	15.2
Service line						
IT and business services	2,202	72.8	0.1	13.1	2.0	18.1
Engineering and R&D Services	502	16.6	2.5	20.7	3.7	23.0
Products & platforms	333	11.0	9.5	-6.6	5.1	-6.5
Clients Contribution						
Top 5	339	11.2	-2.4	-4.2	-	-
Top 10	587	19.4	-1.0	3.7	-	-
Top 20	874	28.9	0.4	5.7	-	-

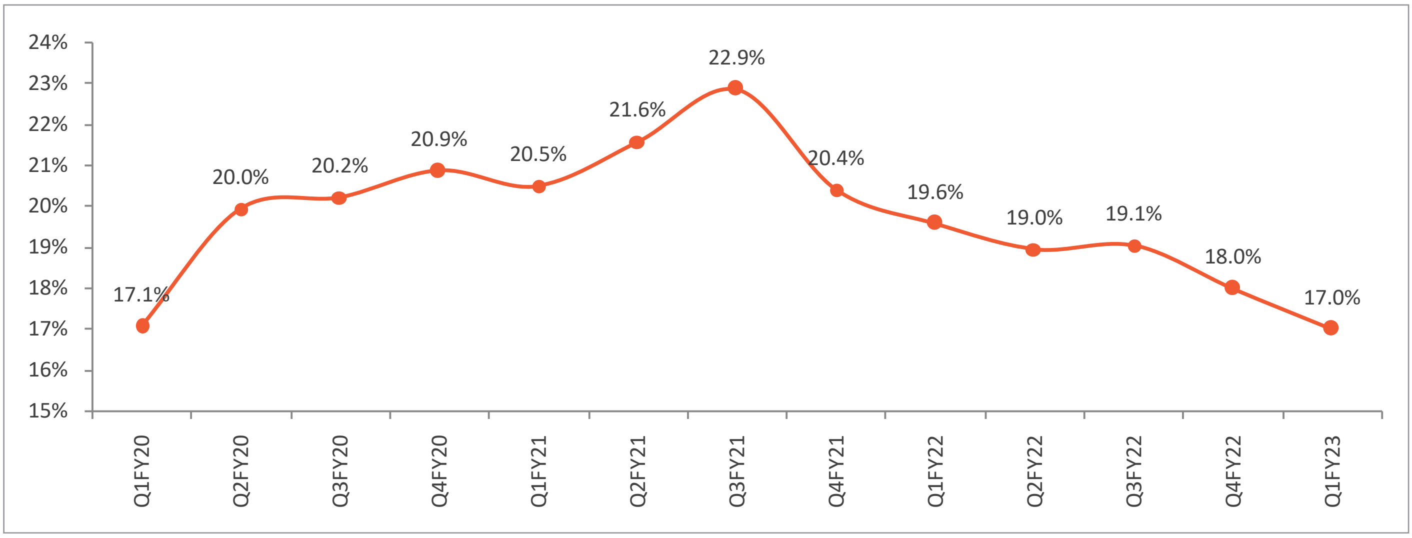
Source: Company; Sharekhan Research

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



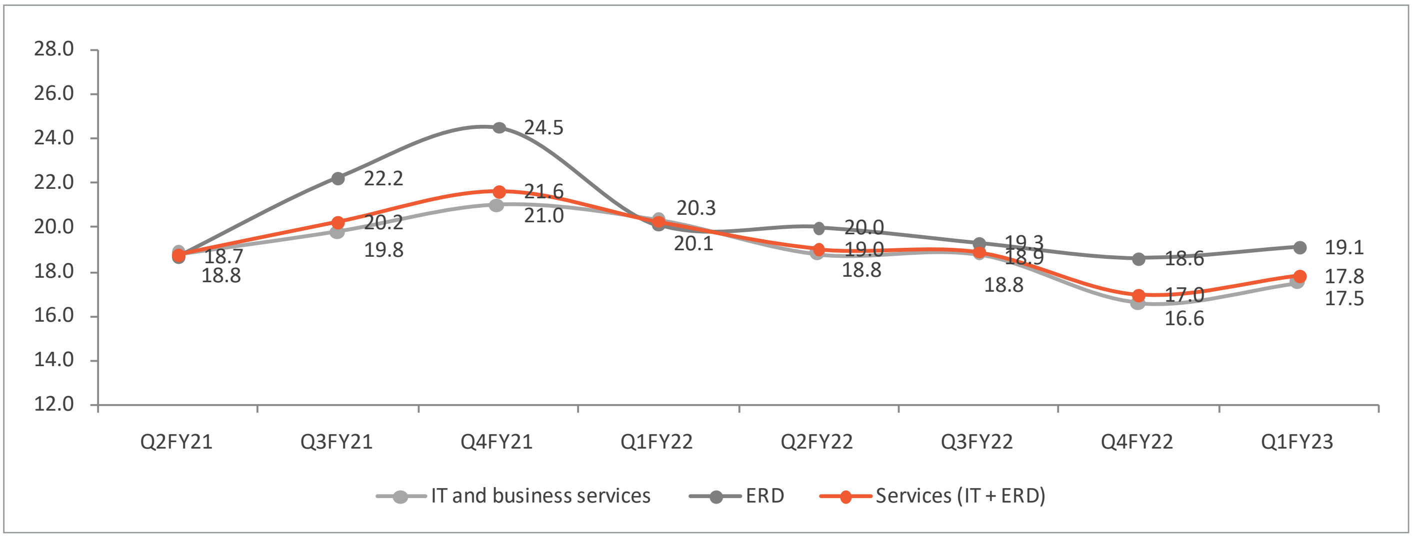
Source: Company, Sharekhan Research

EBIT margin contracted owing to supply-side pressure, rising travel cost and seasonality



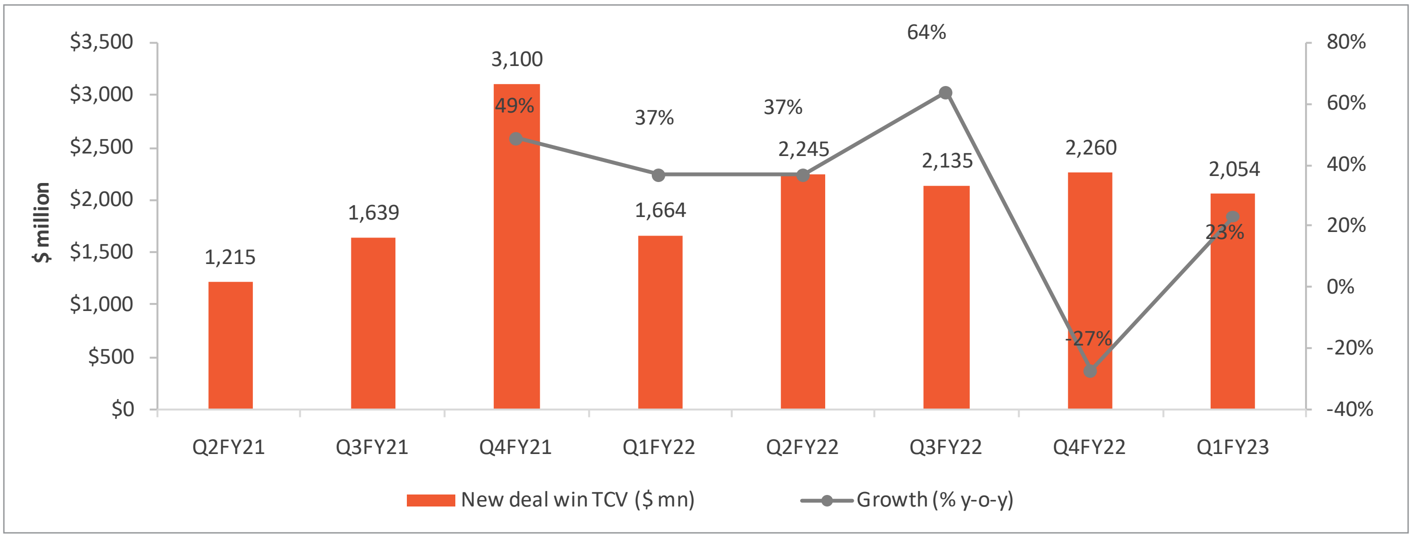
Source: Company, Sharekhan Research

Trend in services (IT+ ERD) EBIT margin



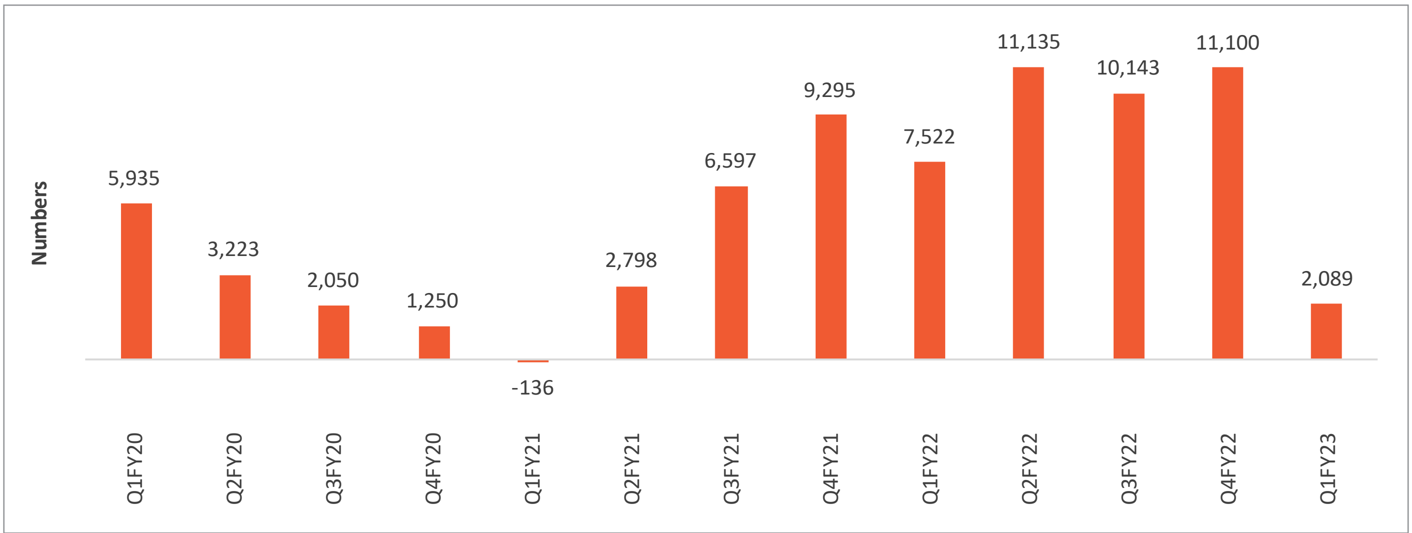
Source: Company, Sharekhan Research

New deal wins TCVs trend



Source: Company, Sharekhan Research

Net headcount addition moderated



Source: Company, Sharekhan Research

Outlook and Valuation

■ Sector view - Expect acceleration in technology spending going forward

We believe that 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.

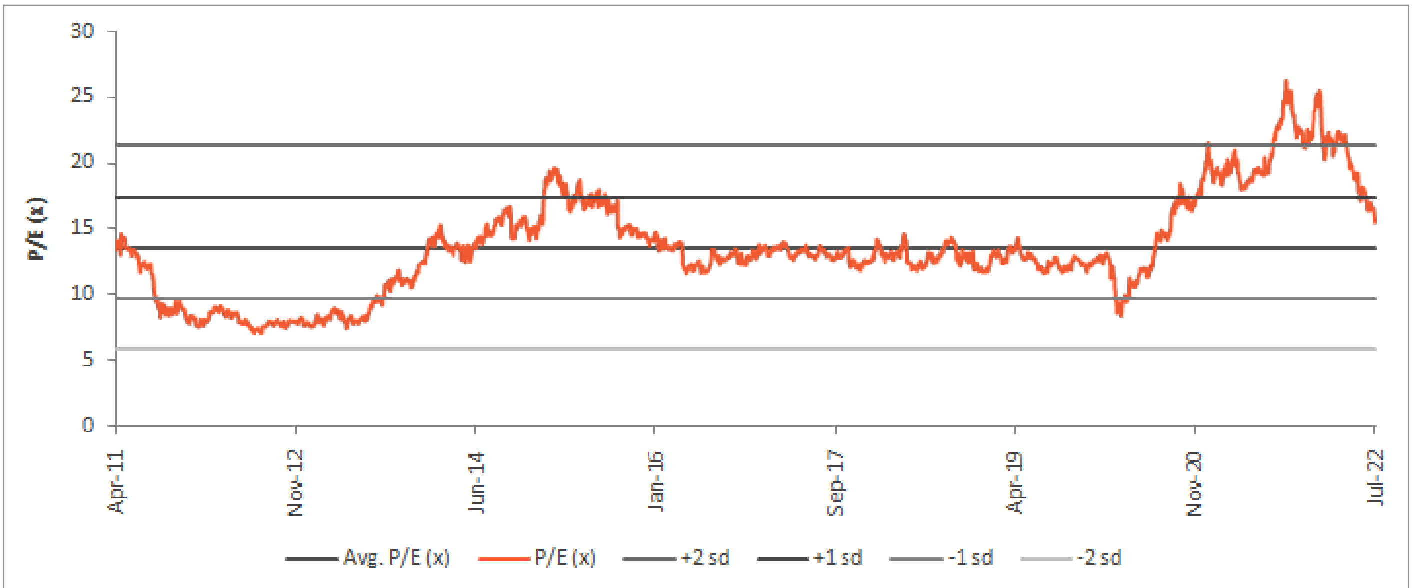
■ Company outlook - Leveraging on core strengths

HCL Technologies has invested aggressively in the fast-growing Mode-2 (a good proxy for digital offering) capabilities, which would help HCL Tech 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 (89% 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. 1,140

HCL Tech is expected to achieve its revenue growth guidance in FY2023E given its strength in digital foundation, unique integrated infrastructure and app services, and leadership in the fast-growing ERD segment. At the CMP, the stock trades at a reasonable valuation of 17x/16x its FY2023E/FY2024E earnings, in-line with its 5-year average valuation. Any further weakness in stock price would turn the risk-reward ratio more favorable. Further, the stock price offers dividend yield of 4.5% at current market price. We continue prefer HCL Tech, given strong capabilities in digital foundation, higher payout ratio, and healthy deal wins. Hence, we maintain Buy on the stock with a price target (PT) of Rs. 1,140.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer Comparison

Companies	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)		EV/EBITDA (x)		P/BV (x)		RoE (%)	
				FY23E	FY24E	FY23E	FY24E	FY23E	FY24E	FY23E	FY24E
Infosys	1,439	421	6,05,266	24.6	21.6	16.5	14.3	4.1	3.7	30.4	31.5
TCS	3,085	366	11,28,689	26.6	23.7	18.2	16.1	11.5	10.0	45.1	45.1
HCL Tech	928	271	2,51,842	17.2	15.5	11.1	10.0	3.8	3.6	22.1	23.0

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 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 andChairman
C Vijay Kumar	Managing DirectorandCEO
Prateek Aggarwal	Chief Financial Officer
Apparao V V	Chief Human Resources Officer
Kalyan Kumar	Chief Technology Officer and Head, Ecosystems

Source: Company

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Life Insurance Corp of India	3.04
2	SBI Funds Management Private Limited	2.62
3	ICICI Prudential Asset Management	2.23
4	Artisan Partners LP	1.89
5	The Vanguard Group Inc.	1.54
6	BlackRock Inc	1.51
7	Aditya Birla Sun Life Asset Management	0.68
8	Nippon Life India Asset Management Limited	0.62
9	Norges Bank	0.55
10	Mirae Asset Global Investment	0.53

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

Sharekhan

by BNP PARIBAS

Know more about our products and services

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