Sharekhan by BNP PARIBAS

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Stock Update

Company Update

HCL Technologies Ltd

Macro headwinds to impact near term growth; valuations reasonable

IT & ITES	Sharekhan code: HCLTECH
Reco/View: Buy ↔	CMP: **Rs. 1,027**
	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. 2,78,775 cr
52-week high/low:	Rs. 1,359 / 876
NSE volume: (No of shares)	31 lakh
BSE code:	532281
NSE code:	HCLTECH
Free float: (No of shares)	106.6 cr

Shareholding (%)

Promoters	60.7
FII	17.2
DII	16.5
Others	5.6

Price chart

Price performance

(%)	1m	3m	6m	12m
Absolute	-2.4	8.3	1.1	-11.6
Relative to Sensex	-5.6	3.6	-14.1	-18.0

Sharekhan Research, Bloomberg

Summary

- HCL Tech's commentary at its US Investor Day indicated demand concerns due to macroeconomic impact and higher-than-expected furloughs. Management now expects FY23 CC revenue growth to be at lower end of its guidance of 13.5-14.5% while they maintained 18-19% EBIT margin guidance. We see our FY23 CC revenue growth estimate of 14.5% at risk.
- The management hinted at increased vendor consolidation as clients move away from boutique firms and weak vendors. New growth opportunities driven by digital transformation and cost optimisation. Focused on customers with large technology spends (85% of FY22 growth from ~50 accounts (35 existing clients and 15 new accounts).
- We believe that uncertain macros could affect global IT spending visibility for CY2023E especially from discretionary/BFSI verticals. This could affect growth for the IT sector with higher impact on Tier-2 IT players because of vendor consolidation. Nifty IT Index has run-up by 9% since Oct'22 (post Q2FY23 earrings season) and we thus advise investors to be selective with a focus on companies with growth visibility and reasonable valuations.
- We maintain a Buy on HCL Technologies with an unchanged PT of Rs. 1,140, given strong growth in application services, good dividend payout, healthy order intake and reasonable valuations (trades at 16x/14.4x FY24E/FY25E EPS).

HCL Technologies hosted US Investor Day meet on December 08, 2022. Management hinted that macro headwinds to impact demand and furloughs would be higher than expected and thus now expects to achieve lower end of FY23 CC revenue growth guidance of 13.5-14.5%. Margin guidance was maintained at 18-19% for FY23 and aim is to improve it further to 19-20% soon. Management expects vendor consolidation would be more rapid and benefit players like HCL Technologies. Managements' plan is to align its product & services closer to market spending pattern, leverage on digital engineering capabilities to tap avenues of new normal in technology industry, increase focus on large clients having high technology spends (HCL Tech's 85% of FY22 growth from ~50 accounts (35 existing clients and 15 new accounts). We maintain Buy on HCL Technologies with an unchanged PT of Rs. 1,140.

- **Macro impact higher than expected; HCL Tech to achieve lower end of FY23 CC revenue growth guidance 13.5-14.5%:** HCL Tech management commentary hints that demand concern from macro environment are higher than anticipated earlier and furloughs are also high. Thus, discretionary spending in hi-tech, telecom and BFSI amongst other verticals could decline and management now expects to achieve lower end of its FY23 CC revenue growth guidance of 13.5-14.5%. This surprised us negatively as post Q2FY23 earnings con-call, management had raised FY23 CC revenue guidance from 12-14% to 13.5-14.5% given the flow of healthy deal wins and prospects of better realization in quarters ahead. We see risk of ~1 percentage point to our FY23 CC revenue growth estimate of 14.5%.
- **FY23 margin guidance of 18-19% intact, aims to scale-up EBIT margin to 19-20% soon:** The management guided to reach EBIT margin of 19-20% in the near future led by pyramid optimisation (increase in fresher hiring), operational efficiencies and increase in nearshoring (company will double headcount in nearshore locations in the next couple of years due to strong demand for nearshore delivery. Present nearshore headcount is 15,000 in 15 locations). In Q2FY23 con-call, management had lowered FY23 EBIT margin guidance to 18-19% from 18-20%.
- **Vendor consolidation, align products to market need & focus on large clients with tech spends - bodes well for HCL Tech:** The management indicated that vendor consolidation would gain further pace driven by factors like 1) client move away from boutique firms and weak vendors, 2) a challenging macro environment to drive market share gain for large players and would also support new opportunities from cloud-led digital transformation and cost optimisation, and 3) one stop shop for product + support services rather than contract for separate products. HCL Tech is focused to align its products & services closer to market spending pattern, leverage on digital engineering capabilities to tap avenues of new normal in technology industry, increase focus on large clients having high tech spends (HCL Tech's 85% of FY22 growth from ~50 accounts (35 existing clients and 15 new accounts).

Our Call

Valuation – Maintain Buy with an unchanged PT of Rs. 1,140: The Nifty IT Index has run-up by 9% since Oct'22 (post Q2FY23 earrings season) while uncertain macros could impact global CY23 IT spending visibility. Thus, we advise investors to be selective on IT companies which have growth visibility (benefit of vendor consolidation) and reasonable valuation. HCL Tech's stock price has also increased by 10% since October 2022 but offers favorable risk reward at current levels for long term investment given strong capabilities in digital foundation, higher payout ratio, healthy deal wins and reasonable valuation of 18x/16x/14x its FY2023E/FY2024E/FY2024E earnings. Hence, we maintain Buy on the stock with an unchanged 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	1,02,674.0	1,12,070.9	1,22,905.0
OPM (%)	24.0	22.2	23.2	23.5
Adjusted PAT	13,499.0	14,709.0	16,831.9	18,729.4
% YoY growth	4.3	9.0	14.4	11.3
EPS (Rs)	49.7	56.1	64.2	71.4
P/E (x)	20.7	18.3	16.0	14.4
P/B (x)	4.5	4.2	3.9	3.7
EV/EBITDA	12.8	11.8	10.4	9.3
ROE (%)	22.1	22.9	24.6	25.7
ROCE (%)	23.7	26.1	28.3	29.8

Source: Company; Sharekhan estimates

HCL hosted US investor day meet on December 08, 2022. Following are the key takeaways from the analyst meet.

CC revenue guidance for FY23 to be at the lower end of 13.5-14.5%

FY23 revenue guidance in constant currency (CC) terms to be in the lower end of 13.5-14.5% as Q3 furloughs will be higher than expected and there is drop in discretionary spending in hi-tech, telecom and BFSI among other verticals. In Q2FY23 con-call, management had raised FY23 cc revenue guidance from 12-14% to 13.5-14.5% given the flow of healthy deal wins and prospects of better realization in quarters ahead.

Aim is to reach EBIT margin guidance of 19-20% soon

The management guided to reach EBIT margin of 19-20% in the near future led by pyramid optimization (increase in fresher hiring), operational efficiencies and right shoring (increasing offshoring and leveraging nearshoring). In Q2FY23 con-call, management had lowered FY23 EBIT margin guidance to 18-19% from 18-20%.

Focus on improving capital efficiency and returning cash to the shareholders

The company plans to have a pay out of at least 75% of net income over FY22-26. The company does not have big acquisition plans for the next five years and is capital efficient in the services business.

HCL to benefit from the increase in vendor consolidation trend

HCLT to be key beneficiary of the increase in vendor consolidation trend as few large players are not performing well due to the macro challenges. Company will also gain business from smaller IT players due to the holistic shift in operating model where clients now prefer to get both the application development and maintenance work done from the same vendor.

IMS business has potential to grow 2-3x in the next 3-4 years

IMS business grew 2x of market growth in the past 3 years and has the potential to grow 2-3x in the next 3-4 years led by expansion of existing clients, 40-50% growth in new focused countries and strong partnerships with Hyperscalers and technology providers. There is a potential market of $70-80 bn with first-time outsourcers and consolidation of fragmented outsourcing and $100 Bn addressable renewable opportunities over next 3 years.

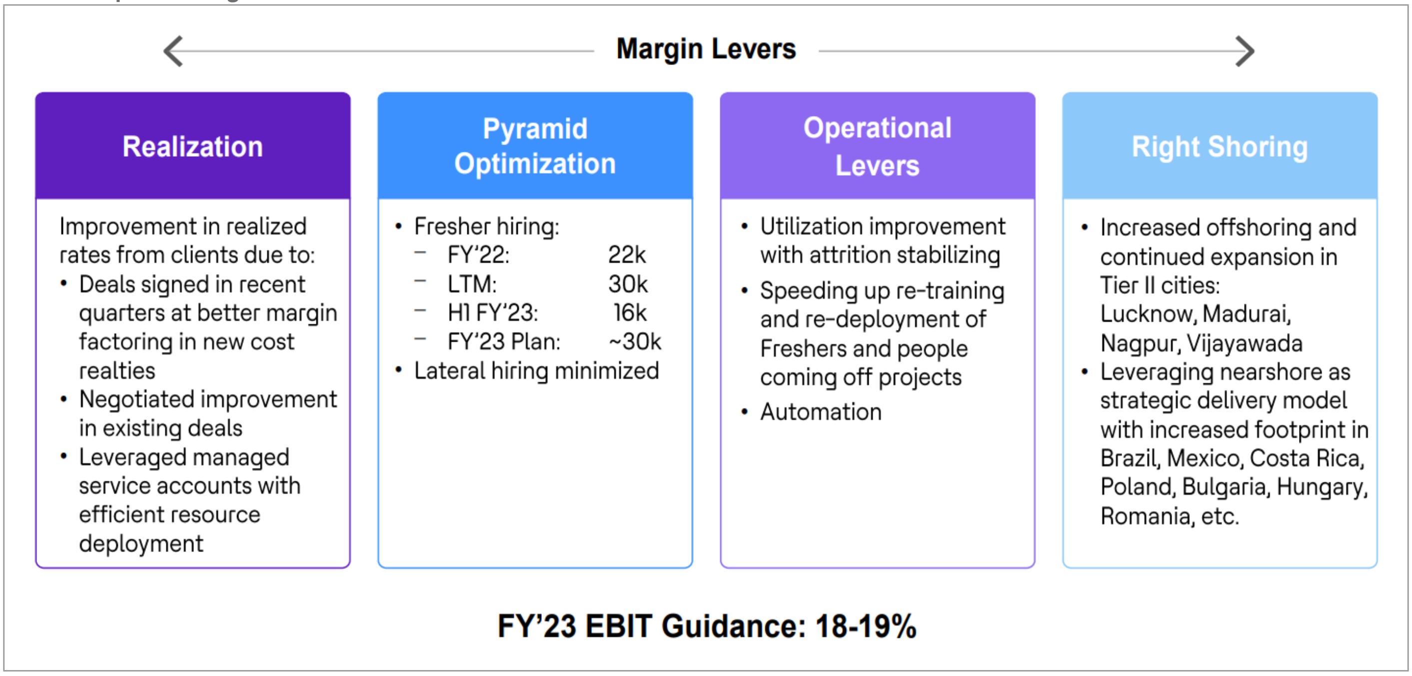
Product business commentary

Growth in products business will take time and the company is focusing on expanding engagement with partners and increasing synergy pipeline in services. Company won a mega deal of $125 Mn ACV in Q2 in services due to synergy benefits.

Strong customer base

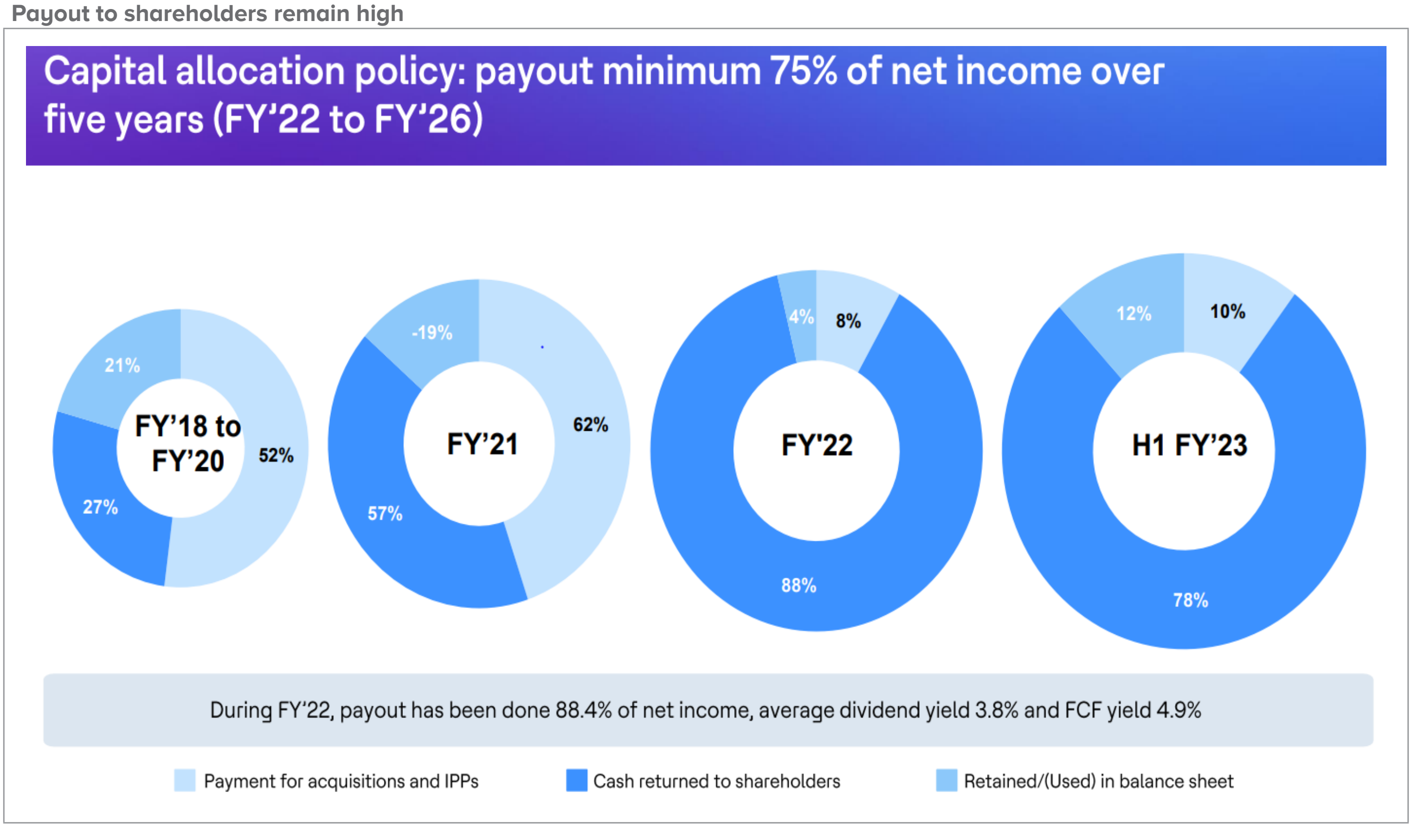
Company has 75+ Fortune 200 companies in the IT & Business services segment which has a TAM of $500 Bn+, 60+ Global R&D Top 100 companies in the ER&D services segment which has a TAM of $90 Bn+ and 240+ Global 500 companies in the HCLSoftware segment which has a TAM of over $100 billion.

Aim to improve margin to 19-20% ASAP



Source: Company

Payout to shareholders remain high



Source: Company

Outlook and Valuation

■ Sector View – Near term macro concern; digital transformation to drive acceleration in technology spending

Amid a challenging macro environment, there is drop in discretionary spending in hi-tech, telecom and BFSI amongst other verticals and thus IT spending could get impacted in near term. However, 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.

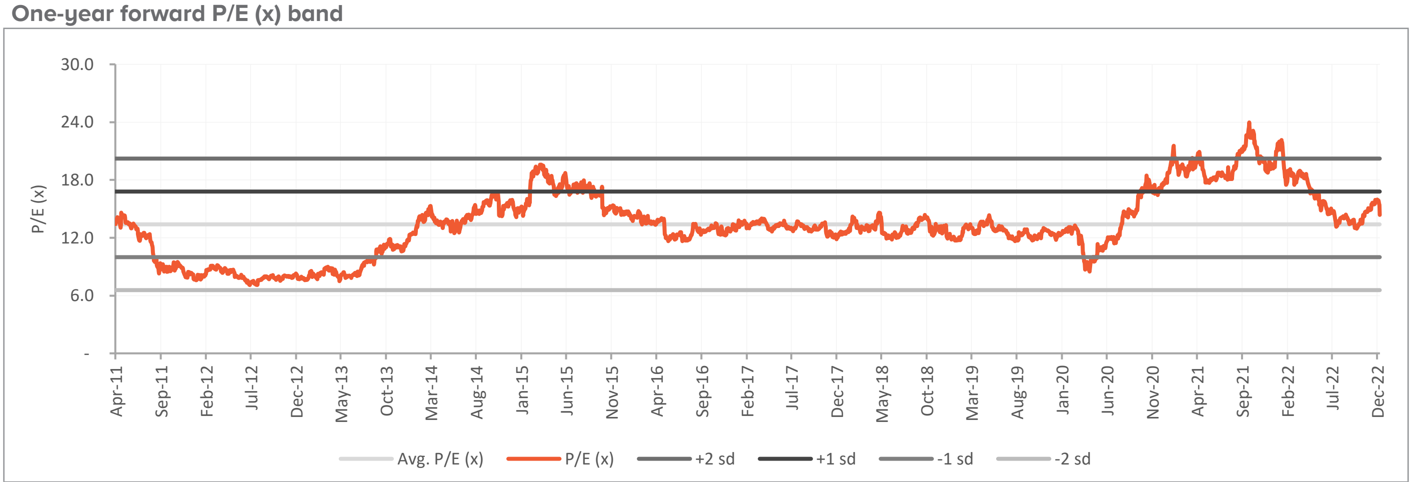
■ Company Outlook – Leveraging on core strengths

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 an unchanged PT of Rs. 1,140

The Nifty IT Index has run-up by 9% since Oct'22 (post Q2FY23 earrings season) while uncertain macros could impact global CY23 IT spending visibility. Thus, we advise investors to be selective on IT companies which have growth visibility (benefit of vendor consolidation) and reasonable valuation. HCL Tech's stock price has also increased by 10% since October 2022 but offers favorable risk reward at current levels for long term investment given strong capabilities in digital foundation, higher payout ratio, healthy deal wins and reasonable valuation of 18x/16x/14x its FY2023E/FY2024E/FY2024E earnings. Hence, we maintain Buy on the stock with an unchanged price target (PT) of Rs. 1,140.

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	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 (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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