

Vendor consolidation opportunity likely provides growth potential...

About the stock: HCL Technologies (HCLT) offers IT, ER&D and products to BFSI, retail, health, telecommunication, manufacturing, media & hi-tech verticals.

- HCL Tech has 250 Fortune 500 and 650 global 2000 clients
- It has grown organically and inorganically (13% CAGR over FY17-22)

Q3FY23 Results: HCLT reported strong numbers aided by P&P.

- The company reported 5% QoQ in CC terms while IT services grew 2.1% QoQ in CC terms. P&P grew 30.5% QoQ in CC terms due to seasonality
- EBIT margin at the company level grew ~160 bps QoQ to 19.6%
- Reported steady TCV of US\$2.3 billion (bn), down 1.6% QoQ & up 9.9% YoY

What should investors do? HCLT's share price has grown by ~2.3x over the past five years (from ~₹ 458 in January 2018 to ~₹ 1,055 levels in January 2023).

- We maintain our **BUY** rating on the stock

Target Price and Valuation: We value HCLT at ₹ 1220 i.e. 19x P/E on FY25E EPS.

Key triggers for future price performance:

- The company continues to win multiyear deals in Cloud transformation, cyber security, etc, as new deal bookings continue to be strong
- Revenue guidance of 13.5-14% revenue growth in CC for FY23E at the company level & IT services guidance of 16-16.5% provided visibility for steady growth
- Revival of P&P business is critical as it is a high margin business
- With improvement in large deal wins, vendor consolidation opportunity, expansion in geographies, investment in sales & capabilities, we expect HCLT to register 12.3% CAGR in revenues over FY22-25E

Alternate Stock Idea: Apart from HCLT, in our IT coverage we also like TechM.

- Key beneficiary of uptick in communication spend
- BUY with target price of ₹ 1,240

Key Financial Summary

Key Financials	FY21	FY22	5 year CAGR (FY17-22)	FY23E	FY24E	FY25E	3 year CAGR FY(22-25E)
Net Sales	75,379	85,651	12.9	1,02,854	1,13,139	1,21,172	12.3
EBITDA	19,482	20,041	14.2	22,319	24,721	26,779	10.1
Margins (%)	25.8	23.4		21.7	21.9	22.1	
Net Profit	12,435	13,516	9.8	14,535	16,052	17,320	8.6
EPS (₹)	45.8	49.8		53.6	59.2	63.9	
P/E	23.0	21.2		19.7	17.8	16.5	
RoNW (%)	20.8	21.8		22.2	23.3	23.9	
RoCE (%)	23.5	24.2		26.2	27.7	29.0	

Source: Company, ICICI Direct Research



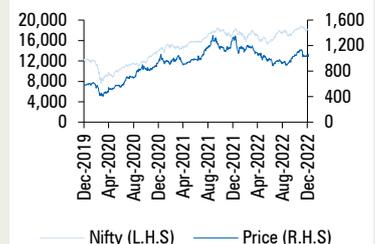
Particulars

Particular	Amount
Market Cap (₹ Crore)	2,86,120.7
Total Debt (₹ Crore)	3,923.0
Cash & Equivalent (₹ Crore)	18,875.0
EV (₹ Crore)	2,71,168.7
52 week H/L	1359 / 878
Equity capital	543.0
Face value	₹ 2

Shareholding pattern

	Dec-21	Mar-22	Jun-22	Sep-22
Promoters	60.3	60.7	60.7	60.7
FII	20.4	19.0	17.9	17.2
DII	13.4	12.7	15.5	16.6
Public	5.9	7.6	5.8	5.6

Price Chart



Recent Event & Key risks

- Cut revenue and EBIT margin guidance at upper level by 50bps
- **Key Risks:** (i) Lower than expected growth (ii) Lower than expected margins

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Key takeaways of recent quarter & conference call highlights

- Reported term:** The company reported rupee revenues of ₹ 26,700 crore, up 8.2% QoQ & 19.6% YoY while dollar revenues came in at US\$3,244 million (mn), up 5.3% QoQ, 9% YoY due to strong growth in P&P business. IT business reported revenue of US\$2,326 mn, up 2.5% QoQ while ER&D business reported revenues of US\$539 mn, up 2.8% QoQ. P&P in its seasonally strong quarter posted a revenue of US\$399 mn, up 32.1% QoQ
- In CC terms:** The company reported growth 5% QoQ revenue growth despite the impact of furloughs. IT business impacted by furloughs reported 2.1% QoQ growth while ER&D grew by 2.5% QoQ. The revenue growth at the company level was aided by P&P business which grew by 30.5% QoQ
- Revenue Guidance:** Due to the furlough impact on the IT services business & normalization of P&P business in Q4 the company has cut the upper end of the revenue guidance to 13.5-14% CC growth for FY23 at the company level & 16-16.5% CC growth for IT services business
- Margin Guidance:** The company cut the upper end of the margin guidance by 50 bps to 18-18.5%. HCLT indicated that margin levers for improvement are pyramid optimisation by fresher deployment, easing of supply side pressure & lower attrition, offshoring & improvement in realisations
- Vertical wise, in CC terms, growth was led by manufacturing, Lifesciences & TMPE reporting growth of 4.9%, 5.5% & 4.5%, respectively, while financial services, technology & retail were laggards with growth of -1.7%, 0.1% & -0.6%, respectively. The company indicated that financial services & technology vertical were impacted by furloughs while retail was down due to rampdown by a large client. The company indicated financial services will rebound in the next quarter on the back of deals won in the previous quarters and though in tech vertical furloughs were unexpected it sees opportunity on the back of vendor consolidation opportunities and increased in offshoring by clients
- Geography wise in CC terms Europe reported growth of 7.2% QoQ while America region (64% of mix) reported flattish growth of 0.5% QoQ. The company indicated that America region growth was impacted by higher-than-expected furloughs
- At the company level, EBIT margin increased ~160 bps QoQ to 19.6% while IT services margin increased ~10 bps. The company indicated the following were the levers for margin improvement at company level: i) +160 bps impact of increased P&P business, ii) +40 bps due to pyramid optimisation gains, iii) +30 bps due to improved realisations & iv) +70 bps due to currency benefit offset by the headwinds of -70 bps impact of wage hikes & -60 bps impact of furloughs
- The company had indicated that it aspires to win TCV of US\$2-2.5 bn every quarter. It delivered it by reporting TCV of US\$2.3 billion (bn), down 1.6%QoQ & 9.9% YoY. The company also mentioned that it won 17 large deals in the quarter of which seven were in IT Services & 10 in P&P
- HCLT net addition for the quarter was soft with addition of 2,945 employees taking its overall employee headcount to 222,270. The company during the quarter hired 5,800 freshers in Q3 taking the total fresher hiring to ~22,000 till YTD December 2022. The company had guided that it will hire at the lower end of 30,000-35,000 fresher in FY23. It, however, now has indicated that the fresher hiring during the year may be lower than it planned as supply side pressure is easing indicating moderate hiring in Q4FY23

- LTM attrition of the company declined 210 bps QoQ to 21.7% and indicated that attrition will moderate further
- The company mentioned that they are seeing vendor consolidation and cost optimisation opportunities ahead, which are now part of their pipeline. HCL Tech said they are incrementally seeing a trend of more cost optimisation deals and, hence, expects future deal pipelines to be skewed towards more cost take out deals. The company is also witnessing a similar trend in the unqualified pipeline and as in when it qualifies, it is likely to take up these opportunities and these opportunities are likely come up somewhere in Q2FY24 or Q3FY24. The company continues to target Global 2000 clients for their growth. HCL Tech also mentioned they continue to aspire preferred IT vendor across the existing clients on basis of end-to-end capabilities and offerings in cloud adoption, data engineering, digital workplace etc. The company added seven new global 2000 clients during the quarter. HCL Tech also indicated that lift and shift is not a bigger opportunity as it is largely applicable for companies with ageing IT landscape while application modernisation and architecture re-designing likely to bring in growth
- The company said that vendor consolidation is one of the growth opportunities ahead. The company indicated that vendor consolidation opportunity could be around US\$115 bn spread over next two to three years. The company indicated that vendor consolidation opportunities are emerging on account of i) clients are now looking for vendors who can offer them end to end capabilities and scale up digital transformation ii) some of the vendors are on weak financial muscle and iii) some architectural change for which clients are looking to source various stacks from the one vendor
- The company indicated that large deal TCV for the quarter also includes three large deals of TCV US\$1 bn. The company also clarified that cost take out program is not a part of this TCV number. The company mentioned that out of these three deals, one deal represents the opportunity wherein client is looking to change overall IT model for the organisation while second deal represents opportunity in vendor consolidation where the company is getting a lion's share. In the third deal, the company is likely to replace struggling existing vendor. The company also mentioned that out of 17 large deals it won during the quarter, two are from BFSI space (one of the deals has TCV around US\$500)
- The company indicated that IT services revenue growth in Q3 was impacted by higher than expected furloughs. However, they expect some recovery in Q4. HCL Tech indicated that the near to medium outlook remains strong on strong deal wins. The company also indicated that deal win numbers are likely to remain in the band of US\$2-2.5 bn in the medium term, which is likely to provide revenue visibility. HCL Tech also mentioned that retail vertical growth in the quarter was also impacted due to stress visible in some clients and ramp down from one client. The company also indicated that furloughs in Telecom & Media also impacted growth for the quarter, which was not the case historically. HCL Tech also mentioned that growth in the Europe vertical was not visible despite strong execution on one of the deals in telecom space there due to significant ramp down from another client in the telecom space there. The company, however, expects the recovery of the same in a couple of quarters, which is expected to drive the growth of the Europe region
- The company mentioned that it aspires to reach 19-20% EBIT margin band in the near to medium term. Some of the levers for the same could be easing of supply side pressure, pyramid optimisation while it called out 'utilisation improvement' to be one of the biggest levers for margin expansion. The company also mentioned that pricing is stable in the market and new deals are coming at the higher pricing. It could be one of the levers for margin expansion in the medium to long term

- The company also mentioned that revenue growth in Q4 is likely to be weak due to seasonally weak quarter for P&P business. HCL Tech also won large 26 deals in P&P business during the quarter but also mentioned that deal wins in the P&P business are not moving the needle in revenues as deal wins in this business are relatively small in the range of US\$100K to US\$10 mn
- The company declared an interim dividend of ₹ 10 per share

Exhibit 1: Variance Analysis

	Q3FY23	Q3FY23E	Q3FY22	YoY (%)	Q2FY23	QoQ (%)	Comments
Revenue	26,700	26,204	22,331	19.6	24,686	8.2	Reported 5% QoQ CC growth aided by P&P segment posting growth of 30.5% QoQ. IT services reported growth OF 2.1% QoQ due to higher impact of furloughs
Cost of sales (including employee expenses)	17,135	17,190	14,309	19.7	16,236	5.5	
Gross Margin	9,565	9,014	8,022	19.2	8,450	13.2	
Gross margin (%)	35.8	34.4	35.9	-10 bps	34.2	159 bps	
Selling & marketing costs	3,200	3,197	2,780	15.1	3,024	5.8	
EBITDA	6,365	5,817	5,242	21.4	5,426	17.3	
EBITDA Margin (%)	23.8	22.2	23.5	36 bps	22.0	186 bps	
Depreciation	1,136	1,048	991	14.6	998	13.8	
EBIT	5,229	4,769	4,251	23.0	4,428	18.1	
EBIT Margin (%)	19.6	18.2	19.0	55 bps	17.9	165 bps	EBIT margin for IT services was up ~10 bps QoQ while at company level the margin improvement levers were : i) +160 bps impact of increased P&P business, ii) +40 bps due to pyramid optimisation gains, iii) +30 bps due to improved realisations & iv) +70 bps due to currency benefit offset by the headwinds of -70 bps impact of wage hikes & -60 bps impact of furloughs
Other income	144	170	203	-29.1	157	-8.3	
PBT	5,373	4,939	4,454	20.6	4,585	17.2	
Tax paid	1,276	1,185	997	28.0	1,096	16.4	
PAT	4,096	3,754	3,443	19.0	3,490	17.4	

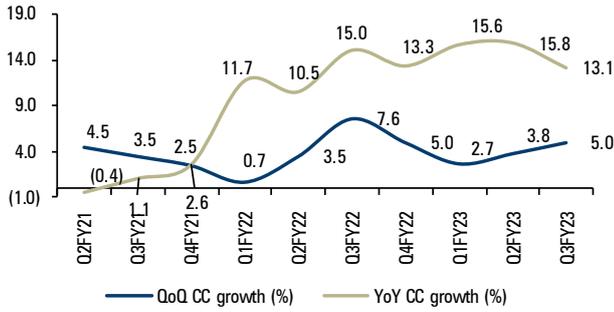
Source: Company, ICICI Direct Research

Exhibit 2: Change in estimates

₹ Crore	FY23E			FY24E			FY25E			Comments
	Old	New	% Change	Old	New	% Change	Old	New	% Change	
Revenue	101,552	102,854	1.3	111,707	113,139	1.3	119,638	121,172	1.3	We revise numbers on higher rupee dollar realisation
EBIT	17,958	18,240	1.6	20,224	20,537	1.5	21,692	22,390	3.2	
EBIT Margin (%)	17.7	17.7	5 bps	18.1	18.2	5 bps	18.1	18.5	35 bps	We bake in margin expansion on easing on supply side
PAT	14,321	14,535	1.5	15,816	16,052	1.5	16,797	17,320	3.1	
EPS (₹)	52.8	53.6	1.5	58.3	59.2	1.5	61.9	63.9	3.1	

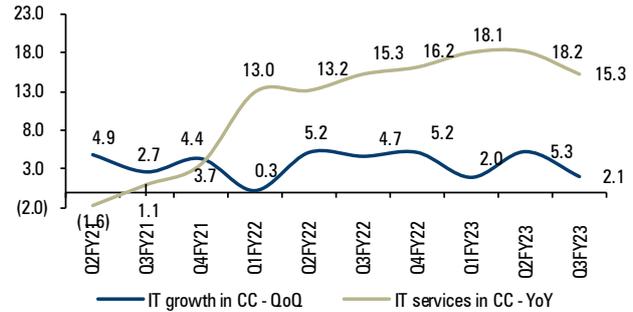
Source: Company, ICICI Direct Research

Exhibit 3: P&P aids revenue growth for quarter



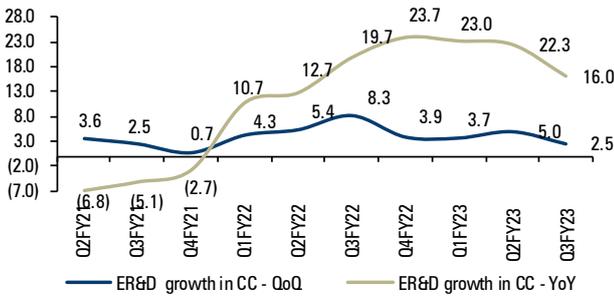
Source: Company, ICICI Direct Research

Exhibit 4: Higher furloughs impact IT services



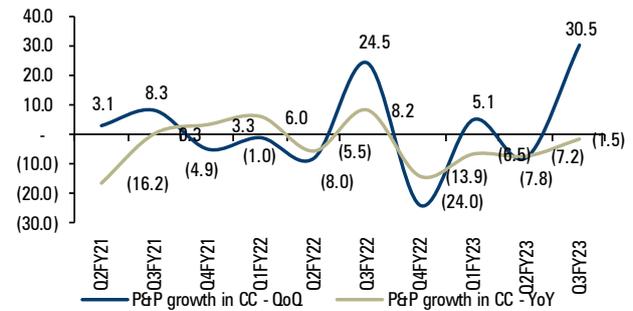
Source: Company, ICICI Direct Research

Exhibit 5: ER&D growth steady QoQ



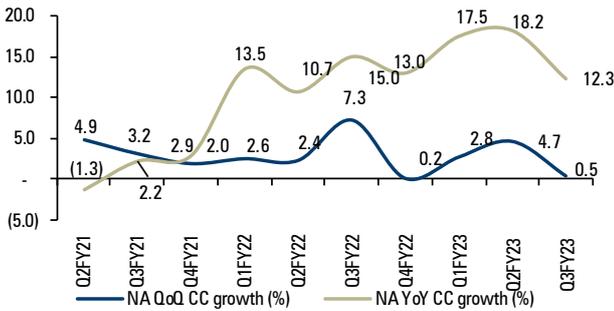
Source: Company, ICICI Direct Research

Exhibit 6: Seasonally strong quarter for P&P



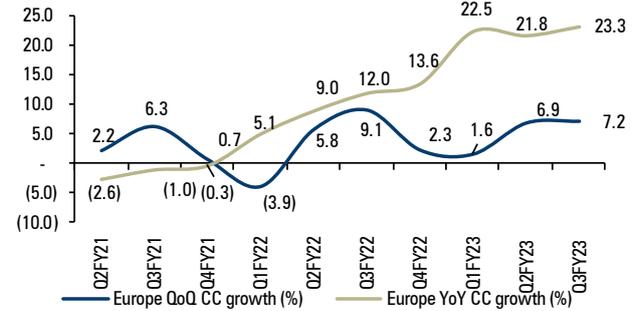
Source: Company, ICICI Direct Research

Exhibit 7: Furloughs impact North America



Source: Company, ICICI Direct Research

Exhibit 8: While Europe continues growth momentum



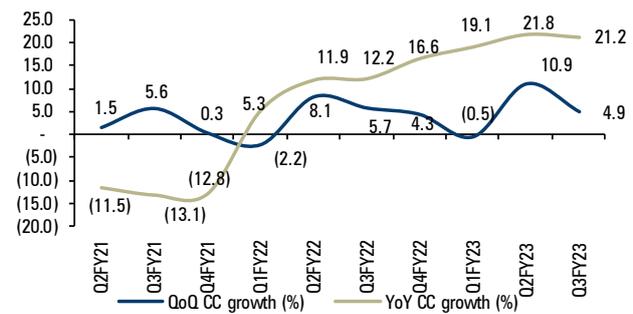
Source: Company, ICICI Direct Research

Exhibit 9: BFSI down in Q3 due to furloughs



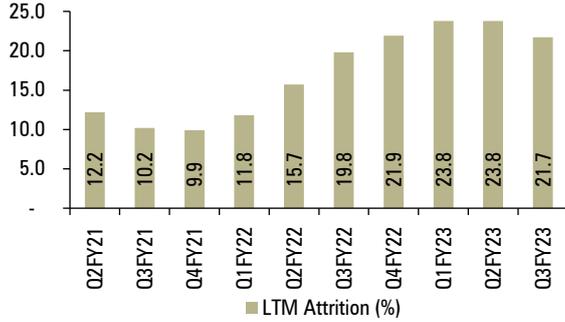
Source: Company, ICICI Direct Research

Exhibit 10: Manufacturing revenue trend



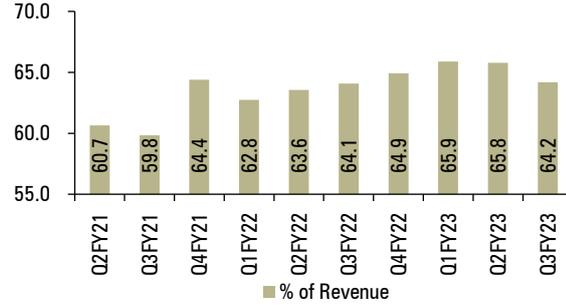
Source: Company, ICICI Direct Research

Exhibit 11: Attrition moderates in Q3



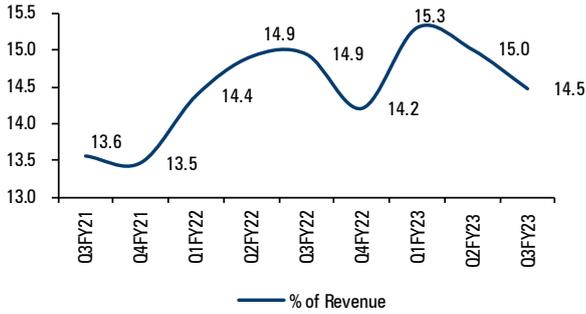
Source: Company, ICICI Direct Research

Exhibit 12: Employee costs moderating



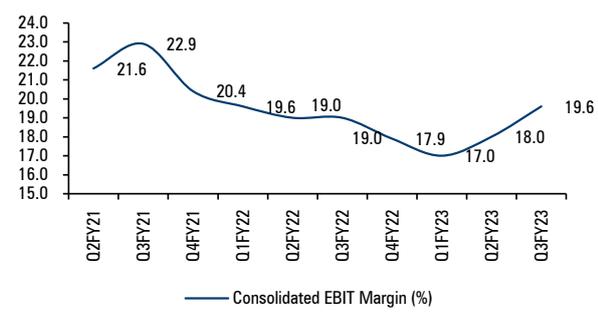
Source: Company, ICICI Direct Research

Exhibit 13: While outsourcing costs continue to decline



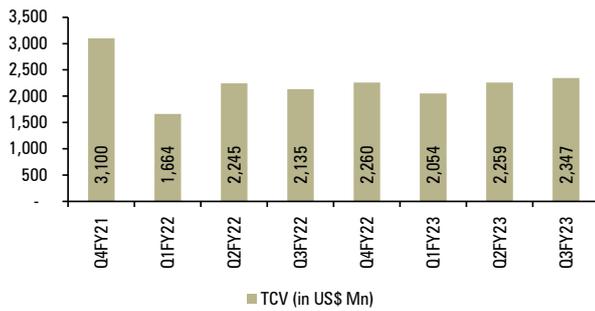
Source: Company, ICICI Direct Research

Exhibit 14: Helping in margin improvement



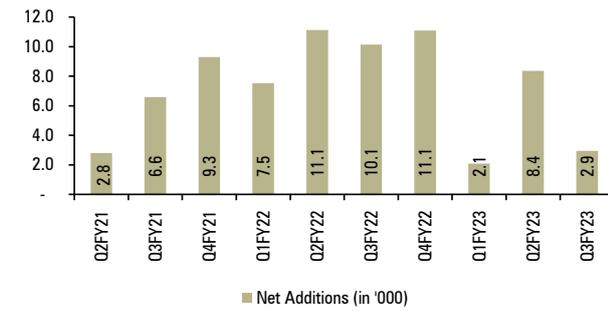
Source: Company, ICICI Direct Research

Exhibit 15: TCV win steady in range of US\$2-2.5 bn



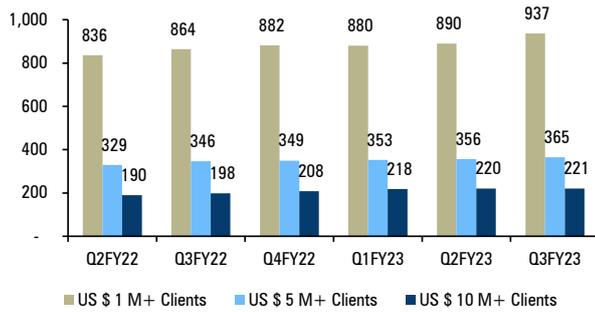
Source: Company, ICICI Direct Research

Exhibit 16: Employee addition soft in Q3



Source: Company, ICICI Direct Research

Exhibit 17: Customer bucket trend



Source: Company, ICICI Direct Research

Exhibit 18: Adds three clients in US\$50 mn YoY



Source: Company, ICICI Direct Research

Financial Summary

Exhibit 19: Profit and loss statement				
	₹ crore			
	FY22	FY23E	FY24E	FY25E
Total operating Income	85,651	1,02,854	1,13,139	1,21,172
Growth (%)	13.6	20.1	10.0	7.1
Direct costs	54,701	66,546	73,088	77,792
S,G&A expenses	10,909	13,988	15,330	16,601
Total Operating Expenditure	65,610	80,534	88,418	94,393
EBITDA	20,041	22,319	24,721	26,779
Growth (%)	2.9	11.4	10.8	8.3
Depreciation	3,874	4,079	4,184	4,389
Amortisation	-	-	-	-
Net Other Income	856	1,076	724	704
PBT	17,023	19,316	21,261	23,094
Forex adjustments	-	-	-	-
Total Tax	3,458	4,732	5,209	5,773
PAT	13,516	14,535	16,052	17,320
Growth (%)	8.7	7.5	10.4	7.9
EPS (₹)	49.8	53.6	59.2	63.9
Growth (%)	8.8	7.5	10.4	7.9

Source: Company, ICICI Direct Research

Exhibit 20: Cash flow statement				
	₹ crore			
	FY22	FY23E	FY24E	FY25E
PBT	17,023	19,316	21,261	23,094
Depreciation & Amortisation	4,326	4,079	4,184	4,079
(Inc)/dec in Current Assets	(2,383)	(8,207)	(3,737)	3,077
Inc/(dec) in CL and Provisions	1,834	5,348	2,554	(2,554)
Taxes paid	(3,443)	(4,732)	(5,209)	(4,732)
CF from operating activities	16,900	14,678	18,328	18,061
(Inc)/dec in Investments	2,994	1,076	724	1,076
(Inc)/dec in Fixed Assets	(1,555)	(1,713)	(1,713)	(452)
CF from investing activities	1,477	(637)	(989)	624
Issue/(Buy back) of Equity	-	-	-	-
Inc/(dec) in loan funds	(60)	(500)	(500)	(500)
Dividend paid & dividend tax	(12,135)	(10,901)	(12,842)	(10,901)
Inc/(dec) in debentures	-	-	-	-
Others	(1,942)	-	-	-
CF from financing activities	(14,508)	(11,401)	(13,342)	(11,401)
Net Cash flow	3,869	2,640	3,998	7,284
Exchange difference	120	-	-	-
Opening Cash	8,888	12,636	15,276	19,274
Bank bal + unclaimed dvd.	-	-	-	-
Cash & bank c/f to balance sheet	12,636	15,276	19,274	26,558

Source: Company, ICICI Direct Research

Exhibit 21: Balance sheet				
	₹ crore			
	FY22	FY23E	FY24E	FY25E
Liabilities				
Equity Capital	543	543	543	543
Reserve and Surplus	61,371	65,005	68,215	71,849
Total Shareholders funds	61,914	65,548	68,758	72,392
Total Debt	3,923	3,423	2,923	2,423
Other liabilities + Provisions	4,329	4,733	4,915	4,733
Minority Interest / Others	92	92	92	92
Total Liabilities	70,258	73,796	76,688	79,640
Assets				
Net Block + CWIP	8,055	7,932	7,763	6,379
Intangible assets + Goodwill	27,160	24,917	22,615	20,372
Investments	103	103	103	103
Liquid investments	6,239	6,239	6,239	6,239
Inventory	161	128	141	128
Debtors	15,476	18,643	20,507	18,643
Loans and Advances	3,008	6,605	7,266	7,266
Other Current Assets	10,521	11,997	13,196	11,997
Cash	12,636	15,276	19,274	26,558
Total Current Assets	48,041	58,888	66,624	70,830
Total Current Liabilities	18,775	23,719	26,091	23,719
Net Current Assets	29,266	35,170	40,533	47,112
Other non current assets	5,674	5,674	5,674	5,674
Application of Funds	70,258	73,796	76,688	79,640

Source: Company, ICICI Direct Research

Exhibit 22: Key ratios				
	₹ crore			
	FY22	FY23E	FY24E	FY25E
Per share data (₹)				
EPS	49.8	53.6	59.2	63.9
Cash EPS	64.1	68.6	74.6	80.0
BV	228.3	241.7	253.5	266.9
DPS	23.6	40.2	47.3	51.1
Cash Per Share	46.6	56.3	71.1	97.9
Operating Ratios (%)				
EBIT Margin	18.9	17.7	18.2	18.5
PBT Margin	19.9	18.8	18.8	19.1
PAT Margin	15.8	14.1	14.2	14.3
Debtor days	66	66	66	56
Return Ratios (%)				
RoE	21.8	22.2	23.3	23.9
RoCE	24.2	26.2	27.7	29.0
RoC	31.5	34.9	40.1	47.8
Valuation Ratios (x)				
P/E	21.2	19.7	17.8	16.5
EV / EBITDA	13.5	12.0	10.7	9.6
EV / Net Sales	3.2	2.6	2.3	2.1
Market Cap / Sales	3.3	2.8	2.5	2.4
Price to Book Value	4.6	4.4	4.2	4.0
Solvency Ratios				
Debt/EBITDA	0.2	0.2	0.1	0.1
Debt/EBITDA	0.2	0.2	0.1	0.1
Current Ratio	1.6	1.6	1.6	1.6
Quick Ratio	1.5	1.6	1.6	1.6

Source: Company, ICICI Direct Research

Exhibit 23: ICICI Direct coverage universe (IT)

Company Name	CMP	TP (₹)	Rating	Mcap (₹)	EPS (₹)			P/E			RoCE (x)			RoE(x)		
					FY22	FY23E	FY24E	FY22	FY23E	FY24E	FY22	FY23E	FY24E	FY22	FY23E	FY24E
HCL Tech (HCLTEC)	1,055	1,220	BUY	2,86,292	49.8	53.6	59.2	21.2	19.7	17.8	24.2	26.2	27.7	21.8	22.2	23.3
Infosys (INFTEC)	1,480	1,730	BUY	6,22,728	52.1	60.7	70.8	28.4	24.4	20.9	36.0	36.2	39.1	29.2	30.1	32.3
TCS (TCS)	3,335	3,780	BUY	12,20,147	104.7	118.5	133.4	31.8	28.1	25.0	51.4	50.1	49.3	43.0	42.6	41.5
Tech M (TECMAH)	1,002	1,240	BUY	97,476	63.1	65.2	80.0	15.9	15.4	12.5	22.5	21.5	23.2	20.7	19.1	20.8
Wipro (WIPRO)	394	420	HOLD	2,15,963	23.5	23.1	26.1	16.8	17.1	15.1	18.8	18.7	20.3	19.6	18.5	20.1
LTIM (LTINFO)	4,279	UR	UR	1,26,571	130.8	155.9*	186.2*	32.7	27.3*	22.9*	32.3	-	-	26.1	-	-
Coforge (NIITEC)	3,903	4,570	BUY	23,771	106.5	147.8	170.8	36.6	26.4	22.9	25.6	31.6	31.2	24.2	28.4	27.8
TeamLease (TEASER)	2,513	2,540	HOLD	4,296	22.5	72.9	88.0	111.8	34.5	28.5	15.4	15.4	16.0	(4.7)	15.1	15.6
Infoedge (INFEDG)	3,719	4,590	HOLD	46,738	35.8	45.5	51.7	103.9	81.8	72.0	4.2	5.4	6.0	3.2	4.1	4.5

Source: Company, ICICI Direct Research

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Buy: >15%

Hold: -5% to 15%;

Reduce: -15% to -5%;

Sell: <-15%



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