MOTILAL OSWAL
FINANCIAL SERVICES

13 July 2023

1QFY24 Results Update | Sector: Technology

HCL Technologies

Estimate change	↔
TP change	↓
Rating change	↔

Bloomberg	HCLT IN
Equity Shares (m)	2714
M.Cap.(INRb)/(USDb)	3012.3 / 36.6
52-Week Range (INR)	1203 / 876
1, 6, 12 Rel. Per (%)	-7/-5/-1
12M Avg Val (INR M)	3178

Financials & Valuations (INR b)

Y/E Mar	2023	2024E	2025E
Sales	1,015	1,101	1,243
EBIT Margin (%)	18.2	17.8	18.4
PAT	148	157	182
EPS (INR)	54.8	57.9	67.2
EPS Gr. (%)	10.0	5.6	16.2
BV/Sh. (INR)	242	239	235
Ratios			
RoE (%)	23.3	24.1	28.4
RoCE (%)	21.1	22.1	26.2
Payout (%)	87.6	90.0	90.0
Valuations			
P/E (x)	20.3	19.2	16.5
P/BV (x)	4.6	4.6	4.7
EV/EBITDA (x)	13.0	12.5	11.0
Div Yield (%)	4.3	4.7	5.5

Shareholding pattern (%)

As On	Mar-23	Dec-22	Mar-22
Promoter	60.8	60.7	60.7
DII	15.3	15.9	14.7
FII	19.2	18.5	19.2
Others	4.7	4.9	5.4

FII Includes depository receipts

CMP: INR1,110 TP: INR1,280 (+15%) Buy

Disappointing 1Q, but attractive valuation factors in weak FY24

Risk of missing FY24 guidance to weigh on near-term returns

- HCL Technologies (HCLT) reported a weak 1QFY24 with revenue of USD3.2b, down 1.3% QoQ in constant currency (CC) and 110bp below our estimate. Continued ramp-downs in Telecom and Technology verticals, mainly in ER&D (-5.2% QoQ in CC), led to the underperformance. Net new deal TCV was also muted at USD1.56b (down 25% QoQ), but the deal pipeline was at all-time high. Despite the weak quarter, HCLT has maintained its FY24 USD revenue growth guidance at 6.0-8.0% YoY in CC (6.5%-8.5% YoY in CC for Services).
- EBIT margin declined 120bp QoQ to 17.0%, missing our estimate by a huge 140bp, despite a 2.5k reduction in workforce (-1.1% QoQ). The miss was led by lower utilization due to project delays and one-time travel costs. The management has retained FY24 EBIT margin guidance at 18.0-19.0%.
- Surprisingly, the management has retained FY24 revenue guidance despite the weak 1Q print. It is confident about the guidance in anticipation of fast scale-up of large deals in IT services and a rebound in ER&D business in Q2. But we see elevated risk to HCLT's growth guidance on account of the steep ask rate over the next three quarters, and hence our estimates are 30bp below (at 5.7% YoY CC) the lower end of the management's guidance band. This implies a strong ~3% CQGR for the next three quarters.
- Additionally, HCLT has decided to skip management level increments (large part of wage bill) and defer increments for others to 3Q, which should aid profitability in the near term. Despite this, we expect HCLT to deliver 17.8% EBIT margin in FY24, 20bp below the management's guidance. The margin should recover to 18.4% in FY25 as growth returns. We expect HCLT to deliver a CAGR of 9.8%/10.8% in USD revenue/INR PAT over FY23-25.
- Our positive view on HCLT remains tethered to its defensive business profile, which should support the company in a demand-constrained environment. This is visible in the company's strong topline expectation between Q2-Q4 (c3% QoQ CQGR), among the best in our Tier 1 coverage despite factoring in growth below the management guidance.
- Moreover, the stock is currently trading at an inexpensive valuation of 16.5x FY25E EPS (4.7% Payout yield) and any near-term correction due to the Q1 miss should make it even more attractive.
- We have lowered our FY24/25 EPS estimates by 1-2% to account for the 1Q miss. Reiterate **BUY** with a TP of INR1,280 (based on 19x FY25E EPS).

Big miss on margins, revenue drag from ER&D

- Revenue declined 1.3% QoQ in CC and 1.1% in USD terms vs. our estimate of 0.2%. New deal TCV stood at USD1.56b (down 25% QoQ) in 1QFY24.
- EBIT margin at 17% was significantly below our estimate of 18.4% (140bp miss).
- For FY24, it has maintained revenue growth guidance at 6-8% YoY in CC (6.5-8.5% CC for Services). EBIT margin guidance has been retained at 18.0-19.0%.

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- LTM attrition was down 320bp QoQ at 16.3%. The net employee headcount declined 2.5k QoQ in 1QFY24.
- LTM OCF to Net Income stood at 135%. Net cash and cash equivalents were at USD2.4b.
- The management declared a dividend of INR10/share.

Key highlights from the management commentary

- The cuts in discretionary spending and delays in projects for telecom and technology continued to impact ER&D in 1QFY24. The management believes that telecom and technology verticals have stabilized and should start to recover from 2QFY24 and the worst is already over for the ER&D vertical.
- Though deal wins were down 25% QoQ in 1QFY24, the pipeline remained at all-time high and should translate to strong conversion in 2QFY24 as many deals are already in advanced stages. The pipeline remains well diversified.
- To maintain margins, the management has decided to skip management level increments (E4 and above; large part of wage bill) and defer increments for others.

Valuations offer a margin of safety; reiterate BUY

- Higher exposure to Cloud, which comprises a larger share of non-discretionary spending, offers better resilience to its portfolio in the current context, with higher demand for Cloud, Network, Security, and Digital workplace services.
- Given its capabilities in the IMS and Digital space, along with strategic partnerships and investments in Cloud, we expect HCLT to emerge stronger on the back of healthy demand for these services in the medium term. The stock is trading at ~16.5x FY25E EPS, which offers a margin of safety. Our TP of INR1,280 is based on 19x FY25E EPS. We reiterate our **BUY** rating.

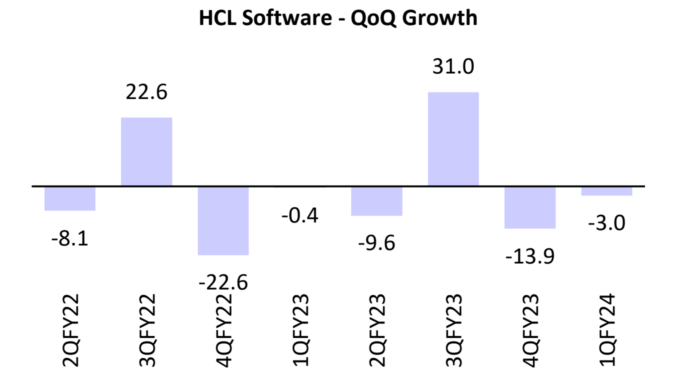
Quarterly performance **(INR b)**

Y/E March	FY23				FY24E				FY23	FY24E	FY24	Var.
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q			1QE	(%/bp)
Revenue (USD m)	**3,025**	**3,082**	**3,244**	**3,235**	**3,200**	**3,293**	**3,448**	**3,484**	**12,586**	**13,425**	**3,245**	**-1.4**
QoQ (%)	1.1	1.9	5.3	-0.3	-1.1	2.9	4.7	1.0	9.6	6.7	0.3	-139bp
Revenue (INR b)	**235**	**247**	**267**	**266**	**263**	**270**	**283**	**286**	**1,015**	**1,101**	**267**	**-1.4**
YoY (%)	16.9	19.5	19.6	17.7	12.1	9.4	5.9	7.4	18.5	8.6	13.7	-160bp
GPM (%)	**35.8**	**35.8**	**37.4**	**36.5**	**35.6**	**35.9**	**36.4**	**36.6**	**36.4**	**36.1**	**36.7**	**-111bp**
SGA (%)	12.9	12.2	12.0	12.8	13.6	13.2	13.0	13.4	12.5	13.3	12.8	81bp
EBITDA	**50**	**54**	**63**	**59**	**54**	**57**	**62**	**62**	**226**	**235**	**60**	**-9.4**
EBITDA margin (%)	21.1	22.0	23.7	22.3	20.5	21.2	21.9	21.8	22.3	21.4	22.4	-182bp
EBIT	**40**	**44**	**52**	**48**	**45**	**47**	**52**	**52**	**185**	**196**	**49**	**-8.9**
EBIT margin (%)	17.0	17.9	19.6	18.2	17.0	17.6	18.3	18.2	18.2	17.8	18.4	-140bp
Other income	3	2	1	4	2	3	3	3	10	11	3	-11.5
ETR (%)	24.3	23.9	23.8	23.4	24.8	24.0	24.0	24.0	23.8	24.2	24.0	81bp
Adjusted PAT	**33**	**35**	**41**	**40**	**35**	**38**	**42**	**42**	**148**	**157**	**39**	**-10.0**
QoQ (%)	-8.7	6.3	17.4	-2.8	-11.2	8.0	9.0	0.3			-1.4	NA
YoY (%)	2.1	6.9	19.0	10.8	7.6	9.4	1.6	4.8	9.9	5.6	19.6	NA
EPS	**12.1**	**12.9**	**15.1**	**14.7**	**13.0**	**14.1**	**15.4**	**15.4**	**54.8**	**57.9**	**14.5**	-10.0

Key performance indicators

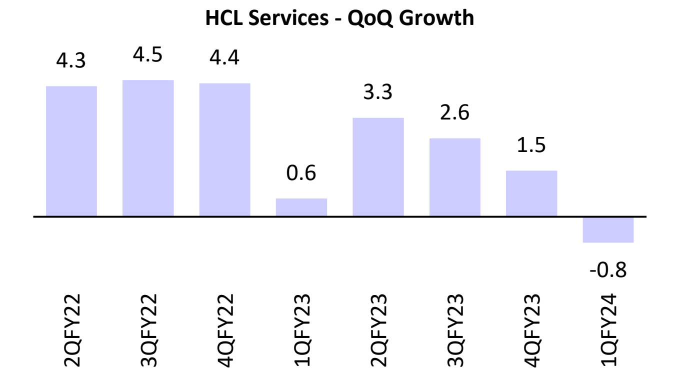
Y/E March	FY23				FY24E				FY23	FY24E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q		
Revenue (QoQ CC %)	**2.7**	**3.8**	**5.0**	**-1.2**	**-1.3**				**13.7**	
Costs (as a percentage of revenue)										
COGS	**64.2**	**64.2**	**62.6**	**63.5**	**64.4**				**63.6**	
SGA	12.9	12.2	12.0	12.8	13.6				12.5	
Margins										
Gross margin	35.8	35.8	37.4	36.5	35.6	35.9	36.4	36.6	36.4	36.1
EBIT margin	17.0	17.9	19.6	18.2	17.0	17.6	18.3	18.2	18.2	17.8
Net margin	14.0	14.1	15.3	15.0	13.4	14.1	14.7	14.6	14.6	14.2
Operating metrics										
Headcount (k)	211	219	222	226	223				226	
Attrition (%)	23.8	23.8	21.7	19.5	16.3				19.5	
Key verticals (YoY CC %)										
BFSI	16.4	15.4	8.8	9.6	14.4				12.4	
Manufacturing	19.1	21.8	21.2	11.8	16.5				18.3	
Key geographies (YoY CC %)										
North America	17.5	18.2	12.3	10.0	7.3				14.4	
Europe	22.5	21.8	23.3	14.6	10.5				20.5	

Exhibit 1: QoQ growth trend in HCL Software (%)



Source: MOFSL, Company

Exhibit 2: QoQ growth trend in HCL Services (%)



Source: MOFSL, Company

Key highlights from the management commentary

Demand and industry outlook

- Growth in 1QFY24 was dragged down by ER&D (-5.2% QoQ CC). IT Services declined 0.1% sequentially in CC. 1QFY24 is generally a weak quarter for HCLT due to productivity commitments.
- Among geographies for Services, growth was dragged down by RoW and Europe (down 6.2% and 2.4% respectively).
- For Services on the industry front, Financial Services, Manufacturing and Life Sciences performed well, while Telecom and Technology declined 14.4% and 7.8% QoQ on CC basis, respectively.
- Gains from the execution of large deals were offset by cuts in discretionary spending in IT Services business.
- The cuts in discretionary spending and delays in projects for telecom and technology continued to impact ER&D in 1QFY24. The management believes that telecom and technology verticals have stabilized and should start to recover from 2QFY24 and the worst is already over for the ER&D vertical.
- On HCL Software, the management is focusing on client success, renewals, and GTM partners. About 10% of bookings for 1QFY24 were driven by partners.
- Though deal wins were down 25% QoQ in 1QFY24, the pipeline remains at all-time high and should translate to strong conversion in 2QFY24 as many deals are already in advanced stages. The pipeline remains well diversified.
- The macro environment remains a concern. HCLT is seeing delays and ramp-downs in discretionary spending. However, there is an uptick in cost optimization and vendor consolidation deals.
- HCLT is currently working on 140+ Generative AI projects. HCLT expects to see an uptick in Gen AI projects. The management believes that the deflationary pressure from Generative AI is still 2-3 years away.
- The management has maintained FY24 growth guidance in the range of 6-8% CC, with +6.5-8.5% CC in Services, despite weak 1QFY24, due to visibility of faster revenue conversion of deals in 2QFY24.

Margin performance

- The negative margin impact from the dip in HCL Software was offset by a one-time gain on the intangible reversal. Sequentially, the margin impact was driven by a 10bp negative impact from forex, 36bp on lower utilization, 33bp on travel and other one-time costs, and 42bp from the absence of one-time benefit compared to last quarter.
- Delays in deal commencement in the later part of the quarter impacted utilization during the quarter.
- To maintain margins, the management has decided to skip management level increments (E4 and above; large part of wage bill) and defer increments for others.
- Higher fresher intake and the release of some productivity commitments will support margins in 2QFY24.
- The management has maintained its FY24 margin guidance at 18-19%.

Other highlights

- On LTM basis, HCLT generated USD2.5b in OCF, translating to 135% of net income.
- LTM attrition moderated to 16.3%, down 320bp QoQ.

Exhibit 3: Europe and RoW remained muted in 1QFY24

Geographies	Contribution to revenue (%)	CC QoQ growth (%)	CC YoY growth (%)
Americas	64.5	0.2	7.3
Europe	28.7	-2.4	10.5
RoW	6.8	-6.2	-6.0

Source: Company, MOFSL

Exhibit 4: Growth was dragged down by Telecom and Technology in 1QFY24

Verticals	Contribution to revenue (%)	CC QoQ growth (%)	CC YoY growth (%)
Financial Services	22.6	5.1	14.4
Manufacturing	19.9	3.6	16.5
Technology	13.4	-7.8	-7.0
Life Sciences and Healthcare	17.5	-1.3	13.4
Telecom MP&E	7.6	-14.4	-11.7
Retail and CPG	9.1	0.3	3.2
Public Services	10.0	-2.2	6.8

Source: Company, MOFSL

Exhibit 5: ER&D remained a drag in 1QFY24

Segments	Contribution to revenue (%)	CC QoQ growth (%)	CC YoY growth (%)
IT and Business Services	74.7	-0.1	9.1
Engineering and R&D Services	15.4	-5.2	-1.8
HCL Software (P&P)	9.9	-3.1	-0.1

Source: Company, MOFSL

Valuations offer a margin of safety

- Higher exposure to Cloud, which comprises a larger share of non-discretionary spending, offers a better resilience to its portfolio in the current context, with higher demand for Cloud, Network, Security, and Digital workplace services.
- Given its capabilities in the IMS and Digital space, along with strategic partnerships and investments in Cloud, we expect HCLT to emerge stronger on the back of healthy demand for these services in the medium term. The stock is trading at ~16.5x FY25E EPS, which offers a margin of safety. Our TP of INR1,280 is based on 19x FY25E EPS. We reiterate our **BUY** rating.

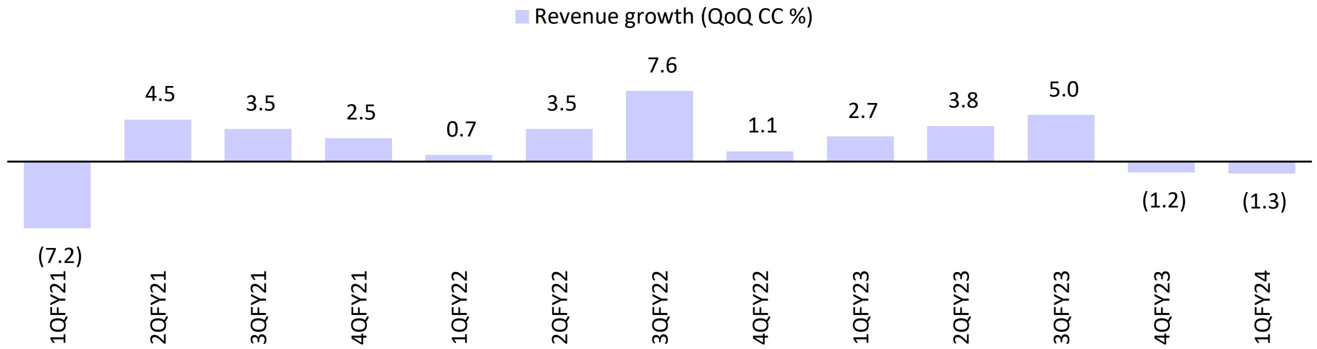
Exhibit 6: Revisions to our estimates

	Revised		Earlier		Change	
	FY24E	FY25E	FY24E	FY25E	FY24E	FY25E
USD:INR	82.0	82.0	82.1	82.0	0.0%	0.0%
Revenue (USD m)	13,425	15,162	13,437	15,101	-0.1%	0.4%
Growth (%)	6.7	12.9	6.8	12.4	-10bps	60bps
EBIT margin (%)	17.8	18.4	18.1	18.7	-30bps	-30bps
PAT (INR b)	157	182	160	185	-2.0%	-1.3%
EPS	57.9	67.2	59.0	68.1	-2.0%	-1.3%

Source: MOFSL

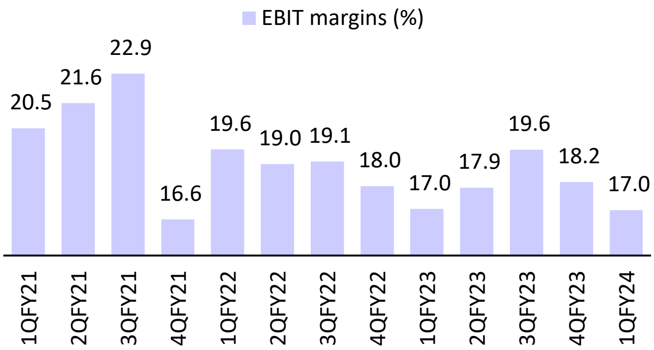
Story in charts

Exhibit 7: Reported 1.3% sequential decline in CC revenue on weak ER&D business



Source: Company, MOFSL

Exhibit 8: Margin further declined in 1QFY24



Source: Company, MOFSL

Exhibit 9: Gross margin saw 90bp QoQ decline

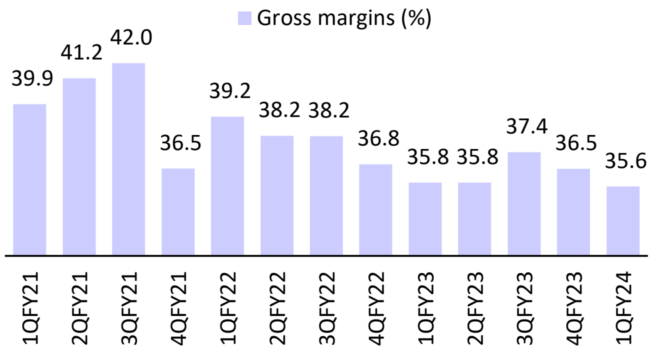
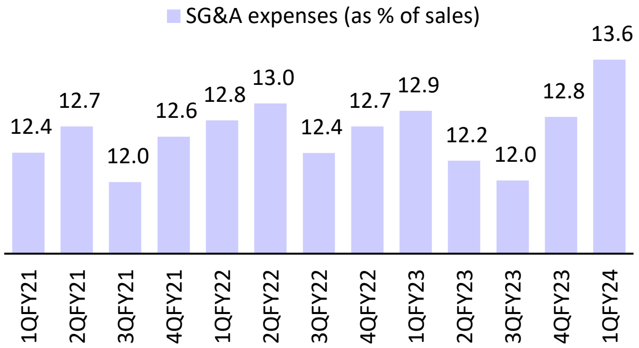
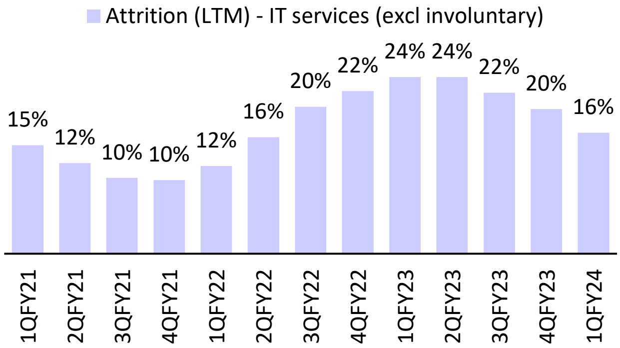


Exhibit 10: SG&A expenses jumped 80bp QoQ in 1QFY24



Source: Company, MOFSL

Exhibit 11: Attrition moderated 320bp in 1QFY24



Source: Company, MOFSL

Operating metrics

Exhibit 12: Operating metrics

	1QFY22	2QFY22	3QFY22	4QFY22	1QFY23	2QFY23	3QFY23	4QFY23	1QFY24
Service-wise (%)									
IT and Business Services	71.6	72.6	70.6	73.4	72.8	73.6	71.7	73.8	74.7
Engineering and R&D Services	15.3	15.7	15.9	16.4	16.6	17.0	16.6	16.1	15.4
Products and Platform	13.1	11.7	13.5	10.3	10.6	9.4	11.7	10.1	9.9
Vertical-wise (Services) (%)									
BFSI	21.9	21.6	21.4	21.6	21.1	20.6	19.9	21.2	22.6
Manufacturing	17.2	17.9	17.5	18.0	18.3	18.3	18.3	18.3	18.3
Technology and Services	17.3	17.2	18.4	17.5	15.4	15.4	15.4	15.4	15.4
Retail and CPG	10.6	9.8	10.8	9.8	9.4	9.2	8.9	9.0	9.1
Telecom MP&E	8.4	8.5	8.4	9.0	9.2	9.2	9.4	8.8	7.6
Life Sciences	14.7	16.7	16.1	16.2	16.4	16.5	17.1	17.5	17.5
Public Services	10.8	10.4	10.3	10.5	10.2	10.2	10.2	10.2	10.0
Geography-wise (Services) (%)									
US	64.2	62.8	63.4	63.1	63.1	64.8	63.5	63.8	64.5
Europe	27.8	28.9	28.7	28.7	28.6	27.5	29.1	28.9	28.7
RoW	8.0	8.3	7.9	8.2	8.3	7.7	7.4	7.3	6.8
Client-wise (%)									
Top five clients	13.0	12.7	12.2	11.6	11.2	10.7	10.3	10.1	9.8
Top 10 clients	20.8	20.7	20.3	19.8	19.4	18.8	18.2	17.7	17.2
Top 20 clients	30.4	29.9	29.4	29.1	28.9	28.6	28.2	27.8	27.2

Source: Company, MOFSL:

Financials and valuations

Income Statement								(INR b)
Y/E March	**FY18**	**FY19**	**FY20**	**FY21**	**FY22**	**FY23**	**FY24E**	**FY25E**
Sales	**506**	**604**	**707**	**754**	**857**	**1,015**	**1,101**	**1,243**
Change (%)	8.2	19.5	17.0	6.7	13.6	18.5	8.6	12.9
Cost of Goods Sold	332	393	453	467	546	662	720	805
Gross Profit	**173**	**212**	**254**	**287**	**311**	**353**	**382**	**439**
Selling and Admin Exp.	59	72	87	93	109	127	146	167
EBITDA	**114**	**140**	**167**	**193**	**202**	**226**	**235**	**272**
As a percentage of Net Sales	22.6	23.1	23.6	25.6	23.6	22.3	21.4	21.9
Depreciation	15	21	28	40	40	41	39	44
EBIT	**100**	**118**	**139**	**153**	**162**	**185**	**196**	**228**
As a percentage of Net Sales	19.8	19.6	19.6	20.4	18.9	18.2	17.8	18.4
Other Income	11	8	2	7	8	10	11	11
PBT	**111**	**126**	**140**	**160**	**170**	**195**	**207**	**240**
Tax	23	25	29	41	34	46	50	58
Rate (%)	20.9	19.6	20.9	25.4	20.3	23.8	24.2	24.0
PAT	**88**	**101**	**111**	**119**	**136**	**148**	**157**	**182**
Net Income	**88**	**101**	**111**	**119**	**135**	**148**	**157**	**182**
Change (%)	3.8	15.3	9.3	7.4	13.7	9.9	5.6	16.2

Balance Sheet								(INR b)
Y/E March	**FY18**	**FY19**	**FY20**	**FY21**	**FY22**	**FY23**	**FY24E**	**FY25E**
Reserves	368	422	517	615	620	654	646	637
Net Worth	**368**	**422**	**517**	**615**	**620**	**654**	**646**	**637**
Loans	4	40	51	39	39	21	21	21
Other liabilities	13	15	55	55	43	45	46	50
Capital Employed	**385**	**477**	**623**	**709**	**703**	**720**	**713**	**707**
Gross Block	274	335	511	546	560	596	640	690
Less: Depreciation	78	100	128	168	208	249	289	332
Net Block	**196**	**235**	**383**	**378**	**352**	**347**	**351**	**357**
Other assets	40	57	65	69	57	51	52	55
Investments	83	55	105	140	85	112	112	112
Curr. Assets	**165**	**243**	**279**	**291**	**397**	**425**	**432**	**447**
Debtors	123	146	178	175	207	255	275	308
Cash and Bank Balance	17	59	38	65	105	91	70	41
Other Current Assets	25	37	64	50	85	80	86	98
Current Liab. and Prov.	**99**	**111**	**209**	**168**	**188**	**214**	**233**	**263**
Net Current Assets	**66**	**131**	**70**	**123**	**209**	**211**	**199**	**184**
Application of Funds	**385**	**477**	**623**	**709**	**703**	**720**	**713**	**707**

Financials and valuations

Ratios

Y/E March	FY18	FY19	FY20	FY21	FY22	FY23	FY24E	FY25E
Diluted (INR)								
EPS	**31.3**	**36.8**	**40.7**	**43.8**	**49.8**	**54.8**	**57.9**	**67.2**
Cash EPS	36.4	44.6	51.2	58.5	64.6	70.1	72.4	83.3
Book Value	131.4	153.5	190.4	226.7	228.6	241.6	238.7	235.3
DPS	6.0	4.0	8.0	26.0	44.0	48.0	52.1	60.5
Payout (%)	59.0	50.4	19.6	59.4	88.3	87.6	90.0	90.0
Valuation (x)								
P/E	35.5	30.2	27.2	25.3	22.3	20.3	19.2	16.5
Cash P/E	30.5	24.9	21.7	19.0	17.2	15.8	15.3	13.3
EV/EBITDA	27.1	21.7	18.1	15.4	14.6	13.0	12.5	11.0
EV/Sales	6.1	5.0	4.3	4.0	3.4	2.9	2.7	2.4
Price/Book Value	8.5	7.2	5.8	4.9	4.9	4.6	4.6	4.7
Dividend Yield (%)	0.5	0.4	0.7	2.3	4.0	4.3	4.7	5.5
Profitability Ratios (%)								
RoE	25.0	25.6	23.6	21.0	21.9	23.3	24.1	28.4
RoCE	22.2	22.8	21.3	18.7	19.6	21.1	22.1	26.2
Turnover Ratios								
Debtors (Days)	88	88	92	85	88	92	91	90
Asset Turnover (x)	2.6	2.6	1.8	2.0	2.4	2.9	3.1	3.5

Cash Flow Statement (INR b)

Y/E March	FY18	FY19	FY20	FY21	FY22	FY23	FY24E	FY25E
CF from Operations	102	123	149	166	174	193	196	226
Chg. in Working Capital	-35	-34	-16	30	-5	-13	-8	-14
Net Operating CF	**68**	**88**	**134**	**196**	**169**	**180**	**189**	**212**
Net Purchase of FA	-49	-61	-18	-18	-16	-14	-44	-50
Net Purchase of Invest.	30	29	-105	-40	30	-25	0	0
Net Cash from Inv.	**-19**	**-32**	**-124**	**-57**	**15**	**-39**	**-44**	**-50**
Issue of shares/other adj.	0	0	0	0	0	0	0	0
Proceeds from LTB/STB	-1	35	-15	-79	-31	-29	0	0
Dividend Payments	-20	-51	-16	-33	-114	-130	-165	-192
Net CF from Finan.	**-21**	**-16**	**-32**	**-112**	**-145**	**-159**	**-165**	**-192**
Free Cash Flow	18	28	115	179	153	166	145	162
Net Cash Flow	**27**	**41**	**-22**	**27**	**39**	**-18**	**-20**	**-29**
Forex difference	-27	5	0	1	1	4	0	0
Opening Cash Balance	**13**	**13**	**60**	**38**	**66**	**106**	**91**	**71**
Closing Cash Balance	**13**	**60**	**38**	**66**	**106**	**91**	**71**	**42**

NOTES

Explanation of Investment Rating	
Investment Rating	**Expected return (over 12-month)**
BUY	>=15%
SELL	< - 10%
NEUTRAL	< - 10 % to 15%
UNDER REVIEW	Rating may undergo a change
NOT RATED	We have forward looking estimates for the stock but we refrain from assigning recommendation

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