13 October 2023

2QFY24 Results Update | Sector: Technology

HCL Technologies

Estimate change	⟷
TP change	⟷
Rating change	⟷

Bloomberg	HCLT IN
Equity Shares (m)	2714
M.Cap.(INRb)/(USDb)	3320.8 / 39.9
52-Week Range (INR)	1311 / 943
1, 6, 12 Rel. Per (%)	-4/1/13
12M Avg Val (INR M)	3163

Financials & Valuations (INR b)

Y/E Mar	2023	2024E	2025E
Sales	1,015	1,094	1,201
EBIT Margin (%)	18.2	18.2	18.6
PAT	148	157	179
EPS (INR)	54.8	58.1	65.9
EPS Gr. (%)	10.0	6.0	13.5
BV/Sh. (INR)	242	239	235
Ratios			
RoE (%)	23.3	24.2	27.9
RoCE (%)	21.1	22.3	25.7
Payout (%)	87.6	90.0	90.0
Valuations			
P/E (x)	22.3	21.1	18.6
P/BV (x)	5.1	5.1	5.2
EV/EBITDA (x)	14.3	13.7	12.2
Div Yield (%)	3.9	4.3	4.8

Shareholding pattern (%)

As On	Jun-23	Mar-23	Jun-22
Promoter	60.8	60.8	60.7
DII	15.4	15.3	15.6
FII	19.2	19.2	18.1
Others	4.6	4.7	5.6

FII Includes depository receipts

CMP: INR1,224 TP: INR1,410 (+15%) Buy

Strong 2HFY24 performance to support valuation

FY24 revenue growth guidance remains punchy but achievable

- HCL Technologies (HCLT) reported a weak 2QFY24 as revenue grew 1.0% QoQ in constant currency (CC) to USD3.2b (below our estimate of 2.9% QoQ CC). HCLT reported consolidated organic growth of 0.5% QoQ CC, with the one-month integration of ASAP contributing 0.5% to overall growth. A slowdown in demand was more pronounced than anticipated in 2Q due to lower discretionary spending and the reprioritization of spending to core operations. ER&D reported 5.0% QoQ CC growth, while organic growth was 1.6% QoQ CC. Despite the softness in 2Q, HCLT reported its highest-ever NN deal TCV of USD3.97b (including Verizon deal) vs. 1.56b in Q1. The deal pipeline remains healthy and HCLT is chasing multiple opportunities in the emerging technologies.
- EBIT margin improved by 150bp QoQ to 18.5%, beating our estimate by 80bp, aided by robust cost-control measures undertaken in 1H and rationalizing employee pyramid. The company saw a second consecutive quarter of net headcount reduction by more than 2k, which, along with the optimization of subcon expenses, contributed significantly to margin improvement. With a strong margin outperformance, HCLT remains confident of achieving its margin guidance of 18-19%.
- While a cut in its FY24 revenue growth guidance (+5.0-6.0% YoY CC from +6.0-8.0% YoY CC earlier) was disappointing, the management has indicated high confidence in achieving the revised guidance due to the ramp-up of the mega Verizon deal, 3Q seasonality in the P&P business and strong bookings in 2Q. This implies a solid quarterly run rate in 2HFY24, which we expect to be the best among our Tier 1 IT services coverage. We expect this to support the share price despite the near-term weakness.
- On the margin front, HCLT's decision to skip management-level increments (large part of wage bill) should aid profitability in the near term. We expect strong revenue growth and continued cost-control measures in 2H to provide operating leverage and support the overall margin improvement. EBIT margin should recover to 18.6% in FY25 as growth returns, leading to a CAGR of 7.2%/9.7% in USD revenue/INR PAT over FY23-25E.
- The stock is currently trading at an inexpensive valuation of 18.6x FY25E EPS (4.8% Payout yield) and any near-term correction should make it more attractive.
- We have lowered our FY24/25 EPS estimates by 1.6/3.0% to account for the 1Q miss. Reiterate **BUY** with a TP of INR1,410 (based on 21x FY25E EPS).

Mixed 2Q, FY24 revenue guidance cut on weak topline

- USD revenue came in at USD3.2b, up 1.0% QoQ in CC (0.8% QoQ reported), below our estimate of 2.9% QoQ.
- Services business grew 1.6% QoQ in CC, with IT services up 0.9% QoQ and ER&D up 5.0% QoQ. ER&D missed our expectation of 8.8% CC growth.

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- EBIT margin saw a sharp improvement of 150bp to 18.5%, beating our estimates of 70bp QoQ. Services EBIT margin rose 210bp QoQ, while P&P was down 350bp QoQ.
- The employee count declined for the second consecutive quarter by 2.3k QoQ vs. 2.5k QoQ in 1Q. Attrition eased further by 190bp QoQ to 14.2%.
- PAT grew 8.4% QoQ to INR38.3b (120bp below our estimates due to high ETR).
- 2Q cash conversion was strong; OCF/NI stood at 151%.
- HCLT declared a dividend of INR12/share.

Key highlights from the management commentary

- Overall, the demand environment is volatile as spending sentiment across enterprises keeps on changing. The management has alluded that it is difficult to project discretionary spending that will bake into the next budget cycle, and also difficult to comment on clients' propensity to spend in this environment.
- The pipeline continues to be heathy, although it has declined 10% from its peak in 2Q as a large mega deal (Verizon) was closed during the quarter.
- With the acquisition of ASAP, the company has broadened its ERS service offerings with a major presence in the automotive segment (Autonomous and connectivity sides).
- The company has maintained its margin guidance, given cost optimization measures carried out in 2Q. Additionally, it expects that the deployment of freshers and managed service engagements are incremental levers to improve margins.

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 amid 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 ~18.6x FY25E EPS, which offers a margin of safety. Our TP of INR1,410 is based on 21x FY25E EPS. We reiterate our **BUY** rating.

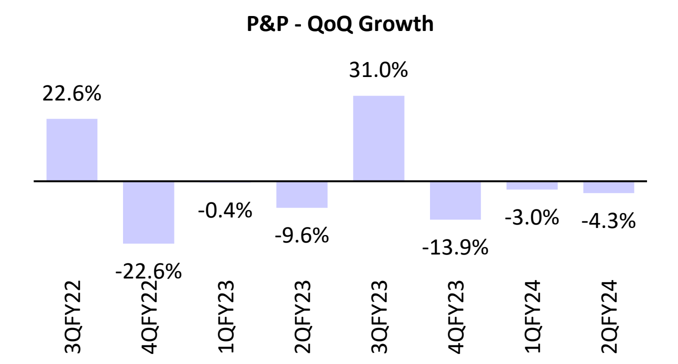
Quarterly performance (INR b)

Y/E March	FY23				FY24				FY23	FY24E	FY24	Var.
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE			2QE	(%/bp)
Revenue (USD m)	**3,025**	**3,082**	**3,244**	**3,235**	**3,200**	**3,225**	**3,393**	**3,401**	**12,586**	**13,219**	**3,297**	**-2.2**
QoQ (%)	1.1	1.9	5.3	-0.3	-1.1	0.8	5.2	0.2	9.6	5.0	3.0	-226bp
Revenue (INR b)	**235**	**247**	**267**	**266**	**263**	**267**	**282**	**282**	**1,015**	**1,094**	**273**	**-2.1**
YoY (%)	16.9	19.5	19.6	17.7	12.1	8.0	5.5	6.1	18.5	7.8	10.4	-234bp
GPM (%)	**35.8**	**35.8**	**37.4**	**36.5**	**35.6**	**36.2**	**36.8**	**36.6**	**36.4**	**36.3**	**36.0**	**21bp**
SGA (%)	12.9	12.2	12.0	12.8	13.6	12.4	12.8	13.2	12.5	13.0	13.2	-79bp
EBITDA	**50**	**54**	**63**	**59**	**54**	**59**	**63**	**62**	**226**	**239**	**58**	**2.1**
EBITDA margin (%)	21.1	22.0	23.7	22.3	20.6	22.2	22.5	22.0	22.3	21.8	21.3	91bp
EBIT	**40**	**44**	**52**	**48**	**45**	**49**	**53**	**52**	**185**	**199**	**48**	**2.4**
EBIT margin (%)	17.0	17.9	19.6	18.2	17.0	18.5	18.8	18.3	18.2	18.2	17.7	82bp
Other income	3	2	1	4	2	2	3	3	10	10	3	-28.8
ETR (%)	24.3	23.9	23.8	23.4	24.8	25.3	24.0	24.0	23.8	24.5	24.0	125bp
Adjusted PAT	**33**	**35**	**41**	**40**	**35**	**38**	**42**	**41**	**148**	**157**	**39**	**-1.0**
QoQ (%)	-8.7	6.3	17.4	-2.8	-11.2	8.4	10.8	-2.6			9.6	-113bp
YoY (%)	2.1	6.9	19.0	10.8	7.6	9.8	3.6	3.9	9.9	6.0	11.0	-114bp
EPS	**12.1**	**12.9**	**15.1**	**14.7**	**13.0**	**14.1**	**15.6**	**15.2**	**54.8**	**58.1**	**14.3**	-1.1

Key performance indicators

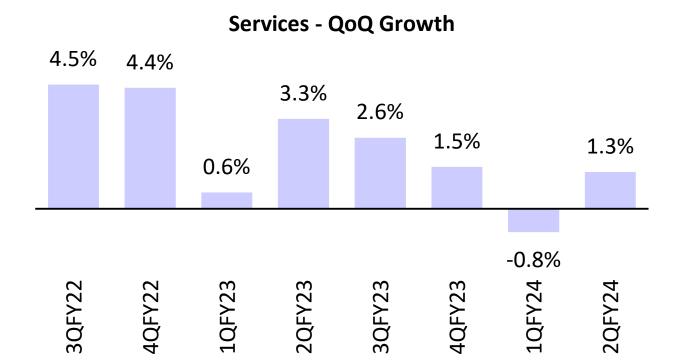
Y/E March	FY23				FY24E		FY23	FY24E
	1Q	2Q	3Q	4Q	1Q	2Q		
Revenue (QoQ CC %)	**2.7**	**3.8**	**5.0**	**-1.2**	**-1.3**	**1.0**	**12.7**	**4.9**
Costs (as a percentage of revenue)								
COGS	**64.2**	**64.2**	**62.6**	**63.5**	**64.4**	**63.8**	**63.6**	**63.7**
SGA	12.9	12.2	12.0	12.8	13.6	12.4	12.5	13.0
Margins								
Gross margin	35.8	35.8	37.4	36.5	35.6	36.2	36.4	36.3
EBIT margin	17.0	17.9	19.6	18.2	17.0	18.5	18.2	18.2
Net margin	14.0	14.1	15.3	15.0	13.4	14.4	14.6	14.4
Operating metrics								
Headcount (k)	211	219	222	226	223	221	226	
Attrition (%)	23.8	23.8	21.7	19.5	16.3	14.2	19.5	
Key verticals (YoY CC %)								
BFSI	16.4	15.4	8.8	9.6	14.4	12.5	12.4	
Manufacturing	19.1	21.8	21.2	11.8	16.5	3.3	18.3	
Key geographies (YoY CC %)								
North America	17.5	18.2	12.3	10.0	7.3	3.9	14.4	
Europe	22.5	21.8	23.3	14.6	10.5	3.9	20.5	

Exhibit 1: P&P segment continues to be weak



Source: MOFSL, Company

Exhibit 2: Service business growth aided by ERD in Q2



Source: MOFSL, Company

CONFERENCE CALL

Key highlights from the management commentary

Demand and industry outlook

- Growth in 2QFY24 was aided by ER&D (+5.0% QoQ CC). IT Services grew 0.9% QoQ in CC. Overall service growth was stood at 1.6% QoQ CC, while organic service growth was 1.0% CC
- Revenue growth in 1H fell below the anticipated line (leading to revision in FY24 revenue guidance) due to a reduction in discretionary spending and the reprioritization of some budgeted spending, which could lead to a near-term dent in growth. However, HCLT expects 2H to contribute meaningfully to revenue growth and help it achieve its revised revenue target.
- The pipeline continues to be heathy, although it has declined 10% from its peak in 2Q as a large mega deal (Verizon) was closed during the quarter. Nonetheless, it sees a strong opportunity in the new and emerging technologies and continues to chase large deals.
- Overall, the demand environment is volatile as spending sentiment across enterprises keeps on changing. The management has alluded that it is difficult to project discretionary spending that will bake into the next budget cycle, and also difficult to comment on clients' propensity to spend in this environment.

- The company expects healthy growth of 2.6%-3.8% CC QoQ in Q3 and Q4, as (1) the ramp-up in large deals will contribute meaningfully to Q3 and Q4; (2) Q3 is a seasonally strong quarter for the software business, as it expects the renewals to come through in the next two months; (3) It expects a ramp-up in deals that were booked in Q2, with some improvement in discretionary spending.
- HCLT reported consolidated organic growth of 0.5% CC QoQ, while another 50bp came from the integration of ASAP (for one month). In service growth, ASAP contributed 60bp QoQ in 2Q. The ERS business reported organic growth of 1.6% QoQ CC vs. 5.0% growth reported in Q2 (including 1-month ASAP integration).
- With the acquisition of ASAP, the company has broadened its ERS service offerings with a major presence in the automotive segment (Autonomous and connectivity sides). With this acquisition, the company has strengthened its foothold in the Germany market with top OEMs as its major clients.
- During the quarter, the company won a strategic USD2b mega deal, where HCLT would be a primary service provider for its enterprise customers and it will participate in the new client acquisition, drive sales and offer managed service solutions to Verizon clients.
- The management has trimmed down FY24 growth guidance. revenue growth guidance (including ASAP acq.) at 5-6% YoY (vs 6-8% YoY CC earlier) while organic growth is expected to the tune of 4-5% CC, Services (Organic) to grow 4.5-5.5% CC (6.5-8.5% CC). EBIT margin guidance kept intact at 18.0-19.0%

Margin performance

- In 2Q, the company saw margin improvement of 150bp — ~210bp came through the service business; ~50bp contributed by a reduction in travel, discretionary spend and cost optimization effort; and 70bp contraction was due to the integration of ASAP.
- The company has maintained its margin guidance, given cost optimization measures carried out in 2Q. Additionally, it expects that the deployment of freshers and managed service engagements are incremental levers to improve margins.
- The company had undertaken a calibrated approach and deliberately optimized costs, where major cuts were witnessed in third-party subcon (down 70bp), normalizing travel costs from its peak in Jun’23. It expects another 50bp margin improvement to come through in the coming quarters.

Exhibit 3: RoW remained muted in 2QFY24

Geographies	Contribution to revenue (%)	CC QoQ growth (%)	CC YoY growth (%)
Americas	64.5	1.4	3.9
Europe	28.5	0.8	3.9
RoW	7.0	6.1	-3.6

Source: Company, MOFSL

Exhibit 4: Growth was dragged down by Manufacturing and Technology in 2QFY24

Verticals	Contribution to revenue (%)	CC QoQ growth (%)	CC YoY growth (%)
Financial Services	22.6	1.7	12.5
Manufacturing	19.3	-1.5	3.3
Technology	13.1	-0.4	-9.5
Life Sciences and Healthcare	17.5	1.6	9.8
Telecom MP&E	8.0	6.2	-10.4
Retail and CPG	9.6	7.5	8.1
Public Services	9.9	0.9	1.7

Source: Company, MOFSL

Exhibit 5: P&P remained a drag in 2QFY24

Segments	Contribution to revenue (%)	CC QoQ growth (%)	CC YoY growth (%)
IT and Business Services	74.6	0.9	4.6
Engineering and R&D Services	16.0	5.0	-2.0
HCL Software (P&P)	9.4	-4.0	3.6

Source: Company, MOFSL

Valuations offer a margin of safety

- Higher exposure to Cloud, which comprises a larger share of non-discretionary spending, offers better resilience to its portfolio in the current context amid 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 ~18.6x FY25E EPS, which offers a margin of safety. Our TP of INR1,410 is based on 21x FY25E EPS. We reiterate our **BUY** rating.

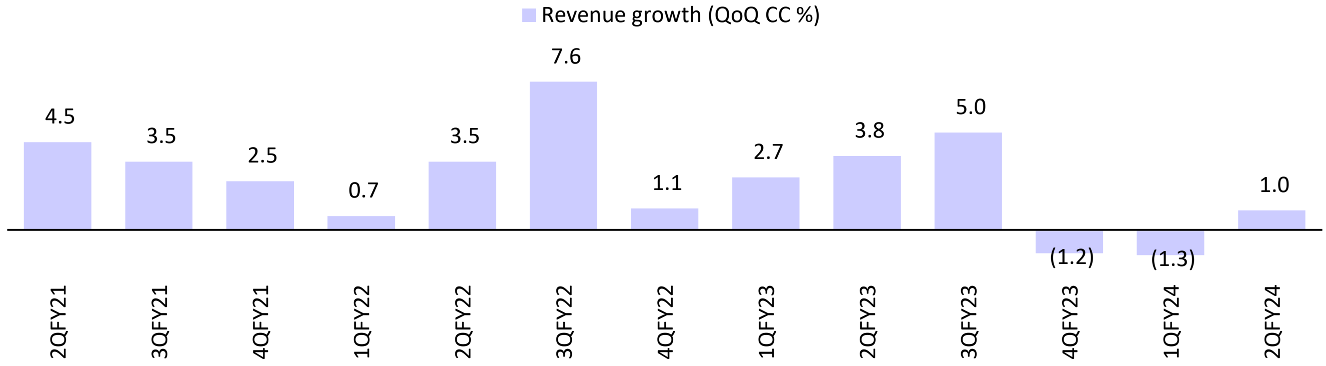
Exhibit 6: Revisions to our estimates

	Revised		Earlier		Change	
	FY24E	FY25E	FY24E	FY25E	FY24E	FY25E
USD:INR	82.7	83.0	82.7	83.0	0.0%	0.0%
Revenue (USD m)	13,219	14,470	13,443	15,129	-1.7%	-4.4%
Growth (%)	5.0	9.5	6.8	12.5	-180bps	-310bps
EBIT margin (%)	18.2	18.6	18.0	18.3	20bps	30bps
PAT (INR b)	157	179	160	184	-1.5%	-2.9%
EPS	58.1	65.9	59.0	67.9	-1.6%	-3.0%

Source: MOFSL

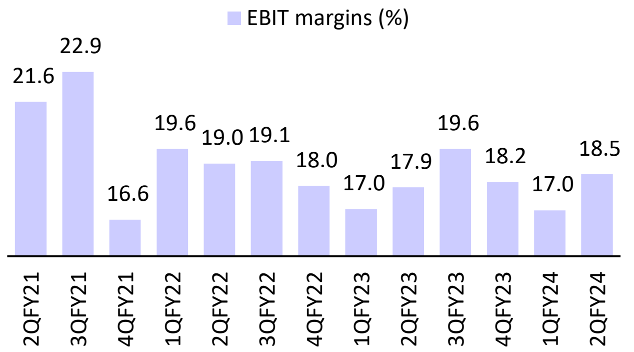
Story in charts

Exhibit 7: Reported weak sequential growth in CC revenue



Source: Company, MOFSL

Exhibit 8: Margin improved substantially in 2QFY24



Source: Company, MOFSL

Exhibit 9: Gross margin saw 60bp QoQ improvement

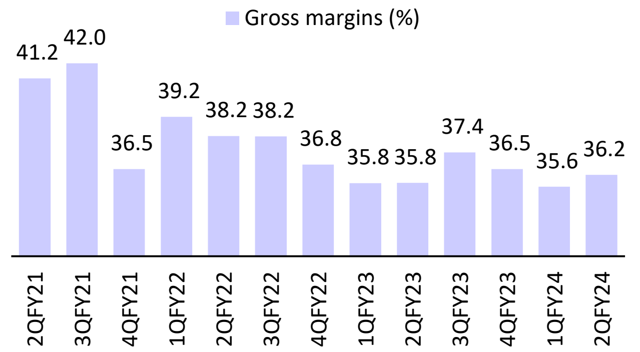
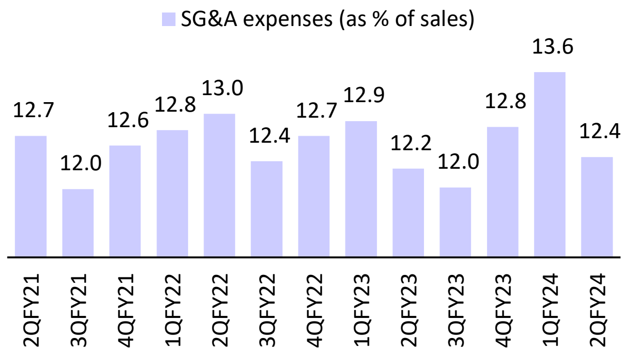
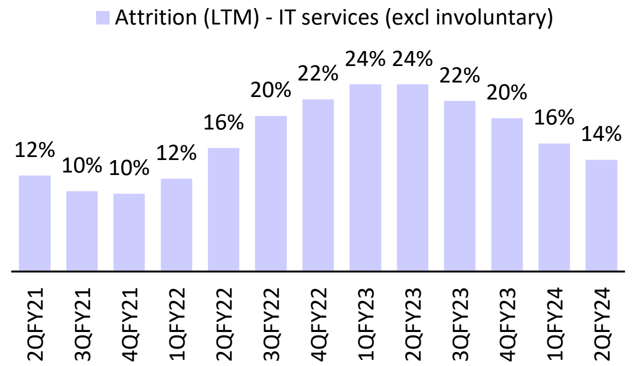


Exhibit 10: SG&A expenses declined sharply in 2QFY24



Source: Company, MOFSL

Exhibit 11: Attrition moderated further 200bp in 2QFY24



Source: Company, MOFSL

Operating metrics

Exhibit 12: Operating metrics

	2QFY22	3QFY22	4QFY22	1QFY23	2QFY23	3QFY23	4QFY23	1QFY24	2QFY24
Service-wise (%)									
IT and Business Services	72.6	70.6	73.4	72.8	73.6	71.7	73.8	74.7	73.8
Engineering and R&D Services	15.7	15.9	16.4	16.6	17.0	16.6	16.1	15.4	16.1
Products and Platform	11.7	13.5	10.3	10.6	9.4	11.7	10.1	9.9	10.1
Vertical-wise (Services) (%)									
BFSI	21.6	21.4	21.6	21.1	20.6	19.9	21.2	22.6	21.2
Manufacturing	17.9	17.5	18.0	18.3	19.2	19.7	19.0	19.9	19.0
Technology and Services	17.2	18.4	17.5	15.4	15.1	14.8	14.4	13.4	14.4
Retail and CPG	9.8	10.8	9.8	9.4	9.2	8.9	9.0	9.1	9.0
Telecom MP&E	8.5	8.4	9.0	9.2	9.2	9.4	8.8	7.6	8.8
Life Sciences	16.7	16.1	16.2	16.4	16.5	17.1	17.5	17.5	17.5
Public Services	10.4	10.3	10.5	10.2	10.2	10.2	10.2	10.0	10.2
Geography-wise (Services) (%)									
US	62.8	63.4	63.1	63.1	64.8	63.5	63.8	64.5	63.8
Europe	28.9	28.7	28.7	28.6	27.5	29.1	28.9	28.7	28.9
RoW	8.3	7.9	8.2	8.3	7.7	7.4	7.3	6.8	7.3
Client-wise (%)									
Top five clients	12.7	12.2	11.6	11.2	10.7	10.3	10.1	9.8	10.1
Top 10 clients	20.7	20.3	19.8	19.4	18.8	18.2	17.7	17.2	17.7
Top 20 clients	29.9	29.4	29.1	28.9	28.6	28.2	27.8	27.2	27.8

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**	**1,094**	**1,201**
Change (%)	8.2	19.5	17.0	6.7	13.6	18.5	7.8	9.8
Cost of Goods Sold	332	393	453	467	546	662	713	776
Gross Profit	**173**	**212**	**254**	**287**	**311**	**353**	**381**	**425**
Selling and Admin Exp.	59	72	87	93	109	127	142	156
EBITDA	**114**	**140**	**167**	**193**	**202**	**226**	**239**	**269**
As a percentage of Net Sales	22.6	23.1	23.6	25.6	23.6	22.3	21.8	22.4
Depreciation	15	21	28	40	40	41	40	46
EBIT	**100**	**118**	**139**	**153**	**162**	**185**	**199**	**224**
As a percentage of Net Sales	19.8	19.6	19.6	20.4	18.9	18.2	18.2	18.6
Other Income	11	8	2	7	8	10	10	12
PBT	**111**	**126**	**140**	**160**	**170**	**195**	**208**	**235**
Tax	23	25	29	41	34	46	51	56
Rate (%)	20.9	19.6	20.9	25.4	20.3	23.8	24.5	24.0
PAT	**88**	**101**	**111**	**119**	**136**	**148**	**157**	**179**
Net Income	**88**	**101**	**111**	**119**	**135**	**148**	**157**	**179**
Change (%)	3.8	15.3	9.3	7.4	13.7	9.9	6.0	13.5

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	48
Capital Employed	**385**	**477**	**623**	**709**	**703**	**720**	**713**	**706**
Gross Block	274	335	511	546	560	596	640	688
Less: Depreciation	78	100	128	168	208	249	290	335
Net Block	**196**	**235**	**383**	**378**	**352**	**347**	**350**	**353**
Other assets	40	57	65	69	57	51	51	53
Investments	83	55	105	140	85	112	112	112
Curr. Assets	**165**	**243**	**279**	**291**	**397**	**425**	**431**	**443**
Debtors	123	146	178	175	207	255	273	297
Cash and Bank Balance	17	59	38	65	105	91	72	51
Other Current Assets	25	37	64	50	85	80	86	94
Current Liab. and Prov.	**99**	**111**	**209**	**168**	**188**	**214**	**231**	**254**
Net Current Assets	**66**	**131**	**70**	**123**	**209**	**211**	**200**	**189**
Application of Funds	**385**	**477**	**623**	**709**	**703**	**720**	**713**	**706**

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**	**58.1**	**65.9**
Cash EPS	36.4	44.6	51.2	58.5	64.6	70.1	72.9	82.7
Book Value	131.4	153.5	190.4	226.7	228.6	241.6	238.5	235.1
DPS	6.0	4.0	8.0	26.0	44.0	48.0	52.3	59.3
Payout (%)	59.0	50.4	19.6	59.4	88.3	87.6	90.0	90.0
Valuation (x)								
P/E	39.1	33.3	30.0	27.9	24.6	22.3	21.1	18.6
Cash P/E	33.6	27.5	23.9	20.9	18.9	17.5	16.8	14.8
EV/EBITDA	29.9	24.0	20.0	17.1	16.1	14.3	13.7	12.2
EV/Sales	6.8	5.5	4.7	4.4	3.8	3.2	3.0	2.7
Price/Book Value	9.3	8.0	6.4	5.4	5.4	5.1	5.1	5.2
Dividend Yield (%)	0.5	0.3	0.7	2.1	3.6	3.9	4.3	4.8
Profitability Ratios (%)								
RoE	25.0	25.6	23.6	21.0	21.9	23.3	24.2	27.9
RoCE	22.2	22.8	21.3	18.7	19.6	21.1	22.3	25.7
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	3.4

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	198	224
Chg. in Working Capital	-35	-34	-16	30	-5	-13	-7	-9
Net Operating CF	**68**	**88**	**134**	**196**	**169**	**180**	**191**	**215**
Net Purchase of FA	-49	-61	-18	-18	-16	-14	-44	-48
Net Purchase of Invest.	30	29	-105	-40	30	-25	0	0
Net Cash from Inv.	**-19**	**-32**	**-124**	**-57**	**15**	**-39**	**-44**	**-48**
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	-166	-188
Net CF from Finan.	**-21**	**-16**	**-32**	**-112**	**-145**	**-159**	**-166**	**-188**
Free Cash Flow	18	28	115	179	153	166	147	167
Net Cash Flow	**27**	**41**	**-22**	**27**	**39**	**-18**	**-18**	**-21**
Forex difference	-27	5	0	1	1	4	0	0
Opening Cash Balance	**13**	**13**	**60**	**38**	**66**	**106**	**91**	**73**
Closing Cash Balance	**13**	**60**	**38**	**66**	**106**	**91**	**73**	**52**

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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