Sharekhan by BNP PARIBAS

Powered by the Sharekhan 3R Research Philosophy

HCL Technologies Ltd

Healthy Q2; deal wins strong but revenue guidance lowered

IT & ITES	Sharekhan code: HCLTECH
Reco/View: Buy ↔	CMP: Rs. 1,224	Price Target: Rs. 1,400 ↑

↑ 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 12.92
Updated Aug 08, 2023

Low Risk

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

Source: Morningstar

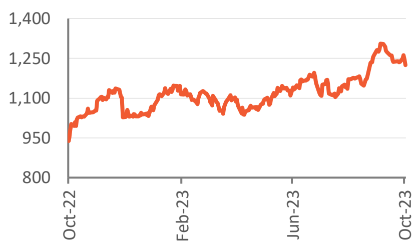
Company details

Market cap:	Rs. 3,32,166 cr
52-week high/low:	Rs. 1,311 / 945
NSE volume: (No of shares)	25.1 lakh
BSE code:	532281
NSE code:	HCLTECH
Free float: (No of shares)	106.6 cr

Shareholding (%)

Promoters	60.8
FII	19.0
DII	15.3
Others	4.9

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	-4.5	6.3	14.2	24.6
Relative to Sensex	-3.3	5.8	4.3	8.6

Sharekhan Research, Bloomberg

Summary

- Q2FY24 numbers were healthy with broadly in-line CC revenue growth of 1% q-o-q and beat of 78 bps in EBIT margin at 18.5%. PAT of Rs. 3,832 crore (up 10% q-o-q) was 5% above our estimate.
- Organic CC revenues grew by 0.5% q-o-q and 0.5% growth was contributed from ASAP acquisition. EBIT margin improvement was led by higher utilization, reduced subcontractor costs and lower discretionary expenses.
- New deal win TCVs grew strongly by 154% q-o-q to ~$4 billion. However, management lowered its FY24 CC revenue growth (including ASAP acquisition) guidance to 5-6% (versus 6-8% earlier) given H1 performance and maintained an EBIT margin guidance of 18-19%. Revised revenue growth guidance implies 3.3-4.5% CQGR for Q3/Q4 of FY24. Services CC revenue growth to be in 2.6-3.8% range for Q3/Q4 of FY24.
- We maintain a Buy on HCL Tech with revised PT of Rs. 1,400 (increase in PT reflects rollover of valuation multiple to FY26E EPS) given robust deal wins and reasonable valuation of 19.4x/17.5x FY25E/FY26E EPS.

HCL Tech reported constant currency (CC) revenue growth of 1% q-o-q (broadly in-line with our estimate of 1.1%) led by healthy CC growth of 1.6% for Services business (IT services/ERS CC revenue growth of 0.9%/5% q-o-q) while Software revenues in cc terms fell by 4% q-o-q (up 3.6% q-o-q). Revenue stood at $3,225 million, up 0.8 % q-o-q/4.6% y-o-y and revenue in rupee terms stood at Rs. 26,672 crore, up 1.4% q-o-q/ up 8% y-o-y. EBIT margin of 18.5% (up 154 bps q-o-q) was 78 bps above our estimate of 17.7% and a sequential improvement reflects higher utilisation, reduced subcontractor cost (70bps benefit) and cut in discretionary expenses like travel (50bps benefit). Net profit stood at Rs. 3,832 crore (up 8.4% q-o-q; up 9.8% y-o-y) and was 5% above our estimate of Rs3,655 crore. The new deal wins TCV increased strongly by 154% q-o-q to $3,969 million and much higher-than-normal quarterly run-rate of $2-2.5 billion. Financial services/Retail & CPG/telecom & media/ Lifesciences & healthcare/public services vertical revenue grew by 1.7%/7.5%/6.2%/1.6%/0.9% q-o-q in CC terms, while that of manufacturing/telecom vertical declined by 1.5%/0.4% q-o-q. Net headcount additions declined by 2,299, taking total headcount to 221,139 while LTM attrition rate significantly declined to 14.2% (versus 16.3% in Q1FY24).

Key positives

- Strong growth of 154% q-o-q in new deal wins TCV to $ 4 billion.
- Beat of 78 bps in EBITDA margin at 18.5%, up 154 bps q-o-q.
- LTM attrition further moderated to 14.2% versus 16.3% in Q1FY24.

Key negatives

- Lowered FY24 CC revenue growth guidance to 5-6% versus earlier guidance of 6-8%.

Management Commentary

- FY24 company CC revenue growth (including ASAP acquisition) guidance lowered to 5-6% (versus 6-8% earlier). Organic company CC revenue growth guidance of 4-5% and Services organic CC revenue growth guidance of 4.5-5.5%.
- EBIT margin guidance maintained at 18-19% for FY24.
- Discretionary spending by clients lagged expectations and still not close to the levels it used to be earlier.
- Pipeline of booking continues to remain strong and its 10% below peak level given robust bookings seen in Q2FY24.
- The company will go ahead with pay revision with effect from October 1, 2023 for 90% of its employees and expect a 60-65 bps margin impact from pay revision.

Revision in estimates – We fine-tuned our FY24-25 earnings estimate and have introduced our FY26 earnings estimate in this report.

Our Call

Valuation – Maintain Buy with revised PT of Rs. 1,400: The management expects revival in H2FY24 given ramp-up of large deal, seasonality benefit for software in Q3 and some recovery in discretionary spending by clients. We estimate healthy revenue/PAT CAGR of 8%/9% over FY23-26E. The stock trades at a reasonable valuation of 19.4x/17.5x its FY25E/26E EPS. Hence, we maintain Buy on HCL Tech with revised price target (PT) of Rs 1,400 (increase in PT reflects rollover of valuation multiple to FY26E EPS).

Key Risks

Rupee appreciation and/or adverse cross-currency movements. The contagion effect of banking crisis, macro headwinds and a possible recession in the US are likely to moderate the pace of technology spending.

Valuation (Consolidated) Rs cr

Particulars	FY22	FY23	FY24E	FY25E	FY26E
Net sales	85,651.0	1,01,456.0	1,07,945.6	1,17,445.0	1,27,666.4
EBITDA Margin (%)	24.0	22.3	22.4	22.8	23.1
Net profit (Rs cr)	13,499.0	14,850.0	15,560.6	17,143.6	18,976.2
% YoY growth	4.3	10.0	4.8	10.2	10.7
EPS (Rs)	49.7	54.7	57.3	63.2	69.9
PER	24.6	22.4	21.3	19.4	17.5
P/B (x)	5.4	5.1	4.8	4.5	4.2
EV/EBITDA	15.9	14.4	13.0	11.3	9.9
ROE (%)	22.1	23.3	23.1	24.0	25.0
ROCE (%)	23.7	26.4	26.9	28.0	29.3

Source: Company; Sharekhan estimates

Key Earnings Call Highlights

- **Revenue guidance lowered; EBIT guidance maintained:** The company has guided for FY24 CC organic revenue growth of 4%-5% y-o-y (vs 6%-8% y-o-y earlier) with services revenue growth expected to be slightly higher between 4.5%-5.5%(vs 6.5%-8.5% y-o-y earlier). The company has guided FY24 CC revenue growth (including ASAP acquisition) of 5%-6%. The company expects FY24 EBIT margin to be between 18%-19%.
- **Geography-wise performance:** Europe, America and RoW grew by 0.8%, 1.4% and 6.1% q-o-q in CC terms respectively in Q2FY24.
- **Net additions disappoint:** LTM attrition significantly declined by 210 bps q-o-q from 14.2% in Q1 to 14.2%. Net addition declined by 2299, taking the total headcount to 221,139.
- **Client metric performance:** The number of clients in the $50 million, $20 million, $10 million categories increased by 1, 5, and 6 q-o-q, respectively. DSO improved to 61 from 64 in Q1FY2024. Revenue from top five clients increased by 0.8% q-o-q, but declined 4.2% y-o-y.
- **Booking performance:** New deal win TCVs stood at $3,969 million, up 154%/66% on a q-o-q and y-o-y basis, respectively. The company won 16 large deals, ten of which were in the services sector and six in the software sector. The deal wins were from diverse sectors like life sciences & healthcare, public services, technology & services, manufacturing, financial services, and retail & CPG among others.
- **Robust cash flows:** OCF/FCF was at 151%/142% of net income on LTM basis. Net cash balance at $2,558 million was up by 6.9% y-o-y.

Results (Consolidated) Rs cr

Particulars	Q2FY24	Q2FY23	Q1FY24	Y-o-Y %	Q-o-Q %
Revenues ($ mn)	**3,224.7**	**3,082.1**	**3,200.0**	**4.6**	**0.8**
Net sales	**26,672.0**	**24,686.0**	**26,296.0**	**8.0**	**1.4**
Direct Costs	17,013.0	15,849.0	16,936.0	7.3	0.5
Gross Profit	**9,659.0**	**8,837.0**	**9,360.0**	**9.3**	**3.2**
Research & development	404.0	388.0	394.0	4.1	2.5
SG&A	3,311.0	3,024.0	3,579.0	9.5	-7.5
EBITDA	**5,944.0**	**5,425.0**	**5,387.0**	**9.6**	**10.3**
Depreciation & amortization	1,010.0	998.0	927.0	1.2	9.0
EBIT	**4,934.0**	**4,427.0**	**4,460.0**	**11.5**	**10.6**
Forex gain/(loss)	-15.0	46.0	-22.0	NA	NA
Other Income	209.0	111.0	258.0	88.3	-19.0
PBT	**5,128.0**	**4,584.0**	**4,696.0**	**11.9**	**9.2**
Tax Provision	1,295.0	1,096.0	1,165.0	18.2	11.2
Net profit	**3,832.0**	**3,489.0**	**3,534.0**	**9.8**	**8.4**
EO	0.0	0.0	0.0		
Reported net profit	**3,832.0**	**3,489.0**	**3,534.0**	**9.8**	**8.4**
EPS (Rs)	14.1	12.7	13.0	10.9	8.4
Margin (%)					
EBITDA	22.3	22.0	20.5	31	180
EBIT	18.5	17.9	17.0	57	154
NPM	14.4	14.1	13.4	23	93
Tax rate	25.3	23.9	24.8	134	45

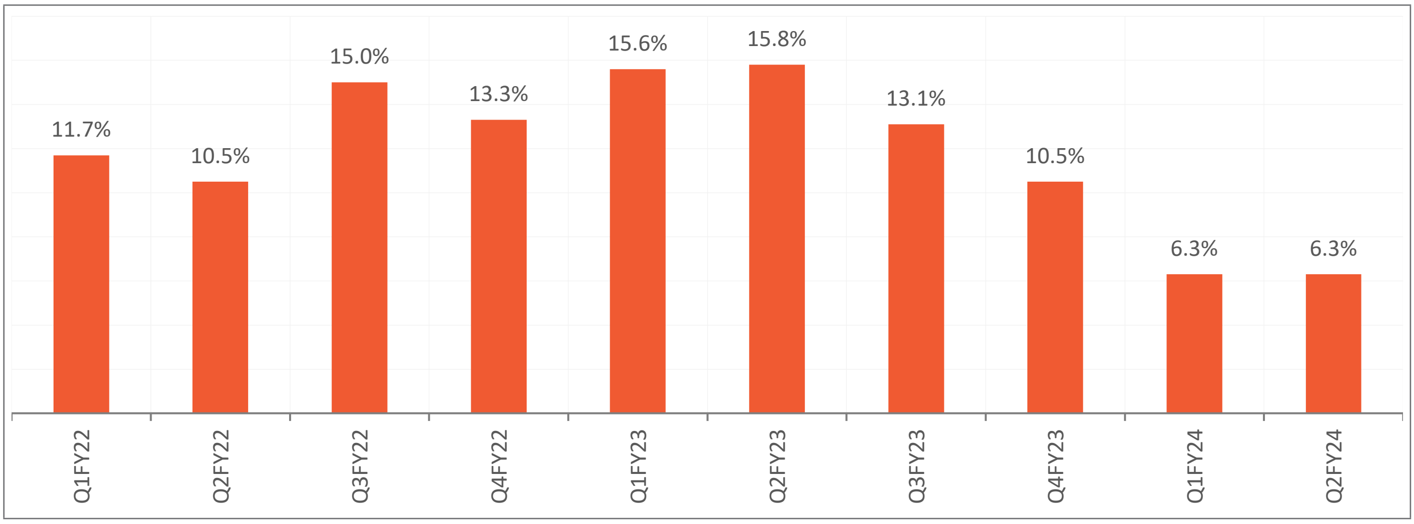
Source: Company; Sharekhan Research

Revenue mix: Geographies, industry verticals, and other operating metrics

Particulars	Revenues ($ mn)	Contribution (%)	$ Growth (%)		CC growth (%)	
			Q-o-Q %	Y-o-Y %	Q-o-Q %	Y-o-Y %
Revenues ($ mn)	3,225	100	0.8	4.6	1.0	6.3
Geographic mix						
Americas	2,080	64.5	0.8	4.1	1.4	3.9
Europe	919	28.5	0.1	8.4	0.8	3.9
RoW	226	7.0	3.7	-4.9	6.1	-3.6
Industry verticals						
Financial services	729	22.6	0.8	14.8	1.7	12.5
Manufacturing	622	19.3	-2.3	5.2	-1.5	3.3
Technology & services	422	13.1	-1.5	-9.2	-0.4	-9.5
Retail & CPG	310	9.6	6.3	9.2	7.5	8.1
Telecommunications, media, publishing & entertainment	258	8.0	6.1	-9.0	6.2	-10.4
Lifesciences & healthcare	564	17.5	0.8	11.0	1.6	9.8
Public services	319	9.9	-0.2	1.5	0.9	1.7
Service line						
IT and business services	2,406	74.6	0.6	6.0	0.9	4.6
Engineering and R&D Services	516	16.0	4.7	-1.5	5.0	-2.0
Products & platforms	319	9.9	-4.1	5.7	-4.0	3.6
Clients Contribution						
Top 5	316	9.8	0.8	-4.2	0.0	0.0
Top 10	555	17.2	0.8	-4.3	0.0	0.0
Top 20	880	27.3	1.1	-0.1	0.0	0.0

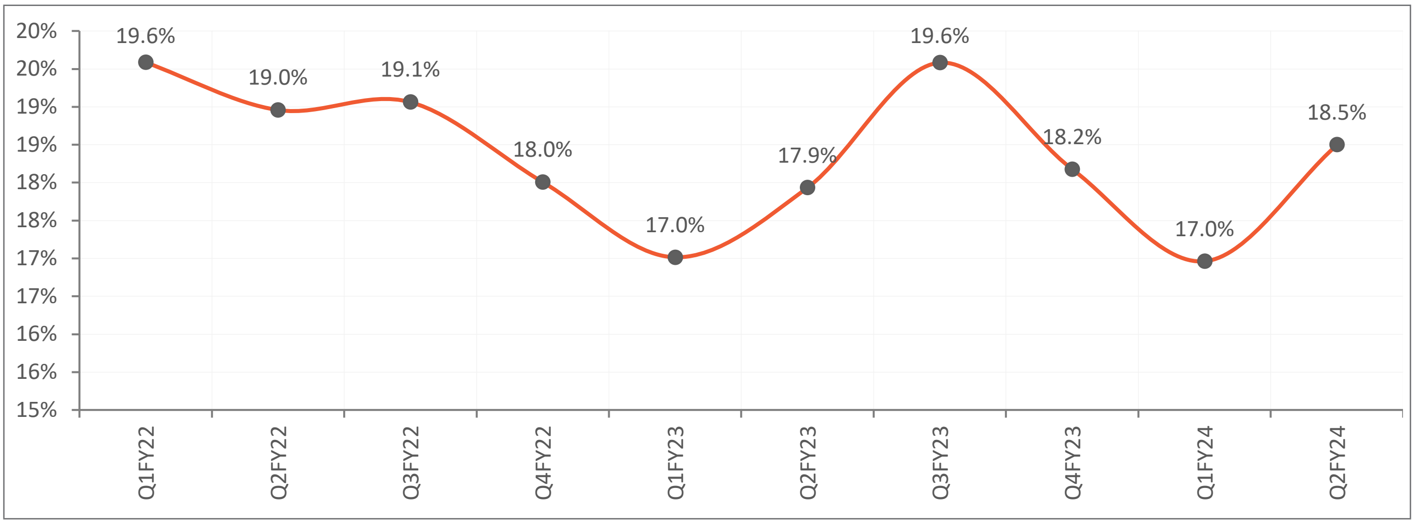
Source: Company; Sharekhan Research

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



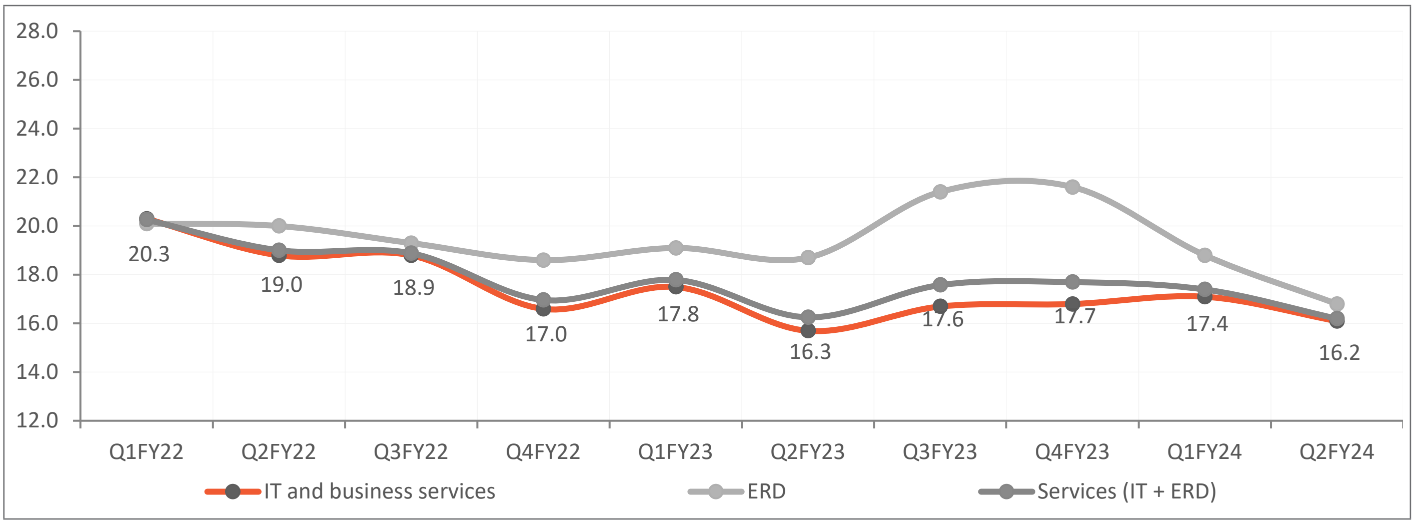
Source: Company; Sharekhan Research

EBIT margin trend



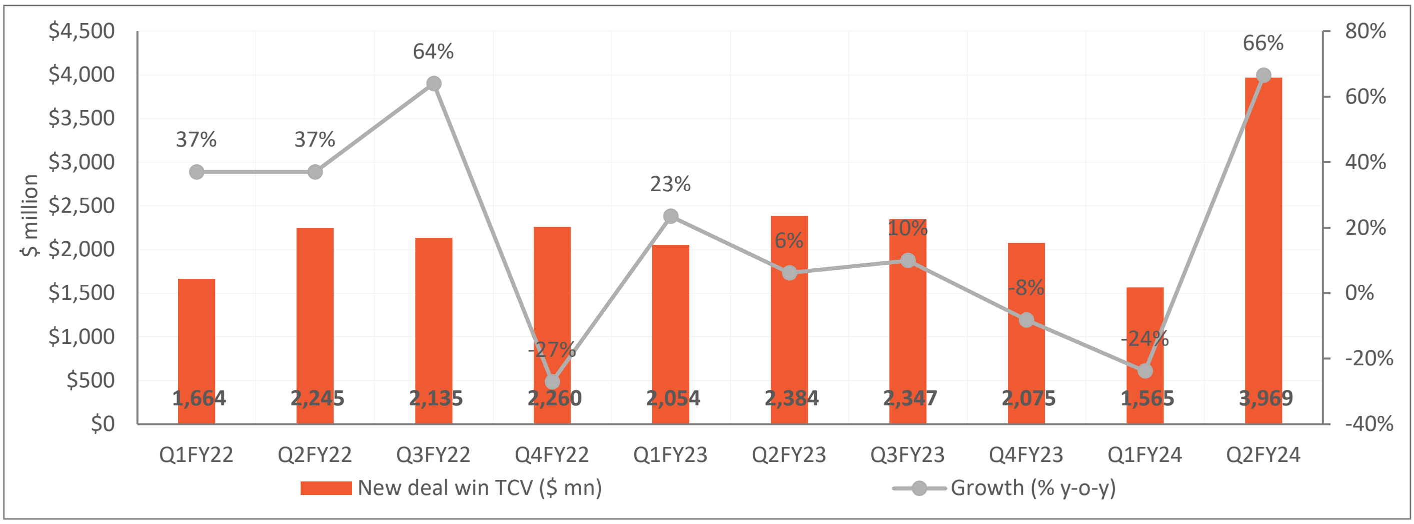
Source: Company; Sharekhan Research

Trend in services (IT+ ERD) EBIT margin



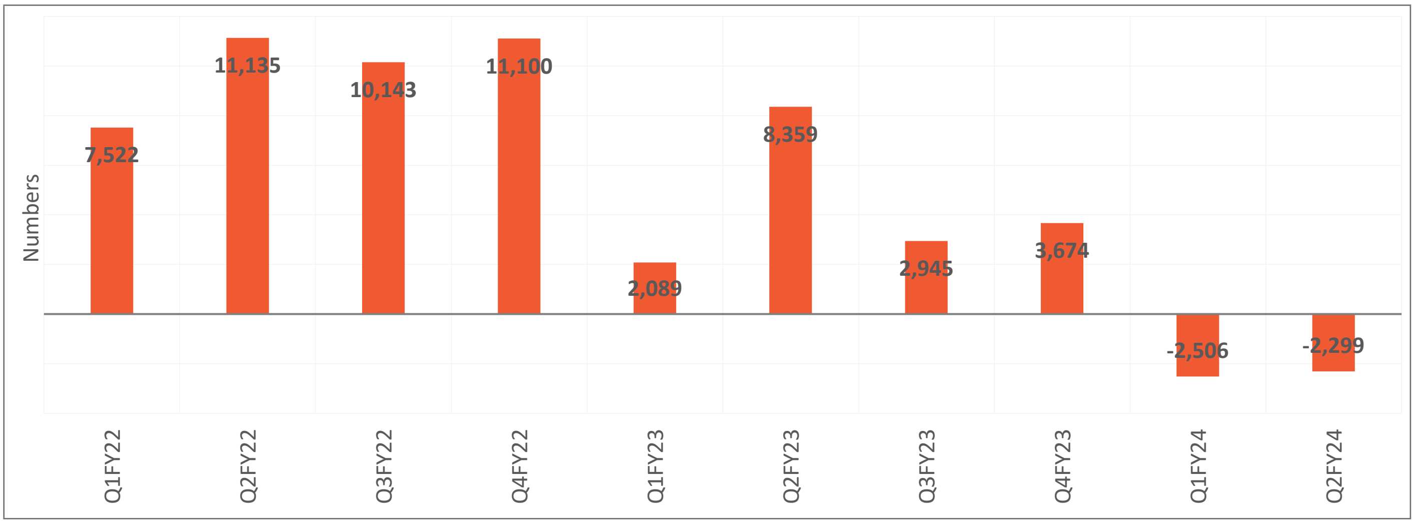
Source: Company; Sharekhan Research

New deal wins TCVs trend



Source: Company; Sharekhan Research

Net headcount addition



Source: Company; Sharekhan Research

Outlook and Valuation

■ Sector View – Persisting multiple global headwinds turning outlook for FY24E uncertain

Owing to multiple global headwinds, the outlook for FY24E looks uncertain, and the recovery could be gradual in the coming quarters. Hence, concerns relating to macroeconomic headwinds are unlikely to abate anytime soon thus restricting any material outperformance for Indian IT companies.

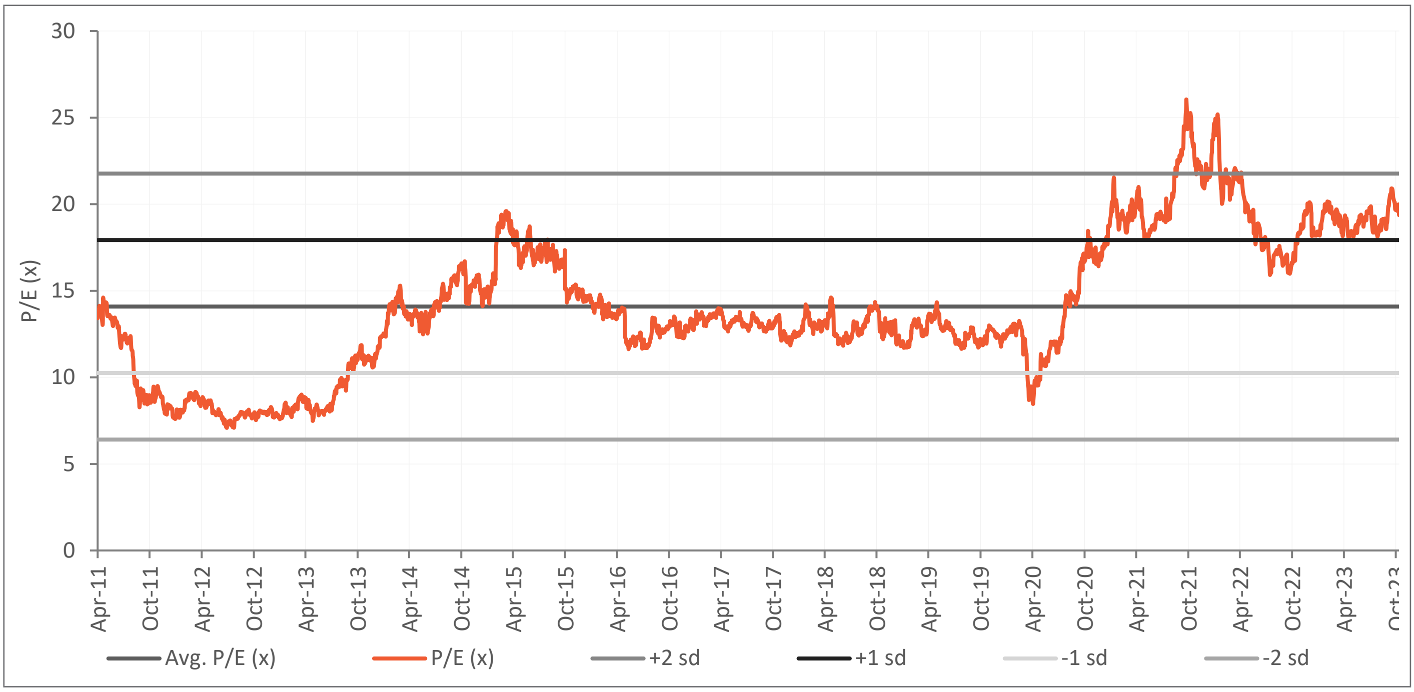
■ Company Outlook – Leveraging on core strengths

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 Infrastructure Management Services (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 digital transformation initiatives for clients.

■ Valuation – Maintain Buy with revised PT of Rs. 1,400

The management expects revival in H2FY24 given ramp-up of a large deal, seasonality benefit for software in Q3 and some recovery in discretionary spending by clients. We estimate healthy revenue/PAT CAGR of 8%/9% over FY23-26E. The stock trades at a reasonable valuation of 19.4x/17.5x its FY25E/26E EPS. Hence, we maintain Buy on HCL Tech with revised price target (PT) of Rs 1,400 (increase in PT reflects rollover of valuation multiple to FY26E EPS).

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

Roshni Nadar Malhotra	Chairperson
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	4.55
2	Artisan Partners Ltd	2.18
3	Vanguard Group Inc/The	1.60
4	BlackRock Inc	1.49
5	SBI Funds Management Ltd	1.44
6	ICICI Prudential Asset Management	1.24
7	HDFC Asset Management Co Ltd	1.13
8	FMR LLC	0.99
9	FIL Ltd	0.75
10	Mirae Asset Global Investments Co	0.72

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

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Other registrations of Sharekhan Ltd.: SEBI Regn. Nos.: BSE / NSE / MSEI (CASH / F&O / CD) / MCX - Commodity: INZ000171337; DP: NSDL/CDSL-IN-DP-365-2018; PMS: INP000005786; Mutual Fund: ARN 20669.

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For any complaints/grievance, email us at igc@sharekhan.com or you may even call Customer Service desk on - 022-41523200 / 022-69920600.