

BUY

TP: Rs 1,440 | ▲ 15%

HCL TECHNOLOGIES

Technology & Internet

15 October 2021

Product business a drag on performance

- Q2 a miss with subdued revenue growth of 2.6% QoQ USD due to 8.4% contraction in product business
- TCV strong at US\$ 2.2bn, up 38% QoQ with 14 large deals. Weak product business profits capped EBIT margin at 19%
- We reduce FY22-FY24 EPS by 6-7% and set our TP at Rs 1,440 (Rs 1,530 earlier); retain BUY

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Growth underperforms: HCLT reported 3.5% QoQ CC revenue growth in Q2FY22, below our (5.5%) and street (5%) estimates. The product and platform (P&P) business disappointed with a revenue decline of 8% QoQ CC (8.4% USD) due to seasonality, whereas the services business (88% of revenue) clocked a strong uptick of 5.2% QoQ CC. Within services, ER&D was up 5.3% and IT & business services (ITBS) grew 4% QoQ USD. ER&D commentary was positive, similar to other peers as asset-heavy industries recovered after multiple Covid waves.

Pick-up in manufacturing and healthcare: Among verticals, growth was led by manufacturing/life-sciences & healthcare/technology services which grew 6.8%/6.8%/2% QoQ USD. BFSI disappointed (-1.1%) while retail and ENU were flattish.

Miss on margins: EBIT margin at 19% declined 60bps QoQ and missed our/street estimates owing to 430bps P&P margin contraction. Services business EBIT margin at 18.9% was flattish sequentially. Employee cost as a percentage of revenue increased 100bps QoQ as HCLT hired ~11k employees in Q2 to backfill attrition which skyrocketed to 15.7% from 11.8% in Q1FY22.

Deal wins remain strong: TCV was at US\$ 2.2bn vs. US\$ 1.7bn in Q1. HCLT bagged 14 new transformational deals in Q2 (including one large product-based contract) vs. 12 deals in Q1. The company saw significant wins from the telecom, BFSI, manufacturing, hi-tech and life-sciences verticals.

FY22 guidance largely intact; product business to remain flat: Management's FY22 outlook of double-digit CC revenue growth and 19-21% EBIT margin is unchanged. HCLT expects a strong Q3 as some deal slippages in Q2 are recouped. Growth in FY22 will hinge on ITBS as the product business is guided to grow only 0-1%.

Retain BUY: We cut EPS estimates to factor in lower growth and margins, translating to a new Sep'22 TP of Rs 1,440, based on an unchanged target P/E of 24.6x. Despite weakness in the product business, we retain BUY given the robust demand climate and strong traction in ITBS driven by cloud services and digital transformation.

Key changes

Target	Rating
▼	◀ ▶

Ticker/Price	HCLT IN/Rs 1,251
Market cap	US\$ 45.1bn
Free float	38%
3M ADV	US\$ 82.5mn
52wk high/low	Rs 1,378/Rs 800
Promoter/FPI/DII	60%/27%/13%

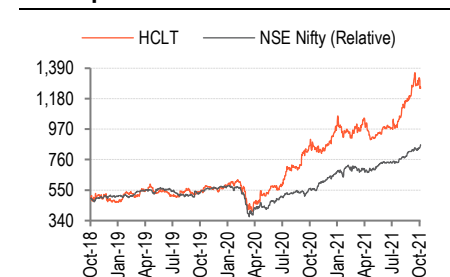
Source: NSE | Price as of 14 Oct 2021

Key financials

Y/E 31 Mar	FY21A	FY22E	FY23E
Total revenue (Rs mn)	753,790	842,705	947,245
EBITDA (Rs mn)	200,560	206,350	240,395
Adj. net profit (Rs mn)	130,660	133,201	149,683
Adj. EPS (Rs)	48.1	49.1	55.2
Consensus EPS (Rs)	48.1	49.8	56.7
Adj. ROAE (%)	22.9	20.3	20.5
Adj. P/E (x)	26.0	25.5	22.7
EV/EBITDA (x)	16.9	16.4	13.8
Adj. EPS growth (%)	17.8	1.9	12.4

Source: Company, Bloomberg, BOBCAPS Research

Stock performance



Source: NSE



Other earnings call highlights

- The P&P business was weak in Q2FY22 due to rollover of a few deals to the next quarter. HCLT has tried to refurbish IBM products by making them cloud native and containerising them, but the process is taking longer than expected. Renewals were robust during Q2 but new license sales of products slowed.
- Account mining improved YoY with one client added in the US\$ 100mn+ bracket, 12 in the US\$ 50mn+, 18 each in the US\$ 20mn+ and US\$ 10mn+, and 12 in the US\$ 5mn+ bracket.
- HCLT plans to expand in other emerging geographies outside India including Romania, Costa Rica and the Philippines in the near future. It has completed one year of operations in Sri Lanka and hired 1,000 locals.
- The board has decided to revise its payout policy by giving out at least 75% of net income over a five-year period. Dividend for Q2 has been announced at Rs 10/sh vs. Rs 6/sh earlier.
- The board announced a new ESOPs scheme to replace the tenor-based variable compensation of top executives. The existing 100% cash incentive payouts will be split into 70% cash and 30% ESOPs. HCLT plans to set up an ESOP trust which will purchase stock from the secondary market that will subsequently be used for stock options. This mechanism will prevent EPS dilution and support the stock price.

Fig 1 – Quarterly performance

(Rs mn)	Q2FY22	Q2FY21	YoY (%)	Q1FY22	QoQ (%)	H1FY22	H1FY21	YoY (%)
Revenues (US\$ mn)	2,791	2,507	11.3	2,720	2.6	5,511	4,863	13.3
Revenue	206,550	185,940	11.1	200,680	2.9	407,230	364,350	11.8
Operating Expenditure	158,170	136,430	15.9	151,600	4.3	309,770	269,180	15.1
Cost of revenues	127,580	109,290	16.7	121,970	4.6	249,550	216,570	15.2
as % of sales	61.8	58.8	-	60.8	-	61.3	59.4	-
SG&A expenses	30,590	27,140	12.7	29,630	3.2	60,220	52,610	14.5
as % of sales	14.8	14.6	-	14.8	-	14.8	14.4	-
EBITDA	48,380	49,510	(2.3)	49,080	(1.4)	97,460	95,170	2.4
Depreciation	9,220	9,350	-	9,770	-	18,990	18,410	3.2
EBIT	39,160	40,160	(2.5)	39,310	(0.4)	78,470	76,760	2.2
Other Income	2,070	1,360	-	1,940	-	4,010	3,410	17.6
PBT	41,230	41,520	(0.7)	41,250	0.0	82,480	80,170	2.9
Total Tax	8,460	9,990	-	8,940	-	17,400	19,280	(9.8)
Adjusted PAT	32,770	31,530	3.9	32,310	1.4	65,080	60,890	6.9
(Profit)/loss from JV's/Ass/MI	(130)	(110)	-	(160)	-	(290)	(240)	-
APAT after MI	32,640	31,420	3.9	32,150	1.5	64,790	60,650	6.8
Extra ordinary items	0	0	-	0	-	0	0	-
Reported PAT	32,640	31,420	3.9	32,150	1.5	64,790	60,650	6.8
Reported EPS	12.0	11.6	3.9	11.8	1.5	24	22	6.8
Margins (%)			(bps)		(bps)			(bps)
EBITDA	23.4	26.6	(320)	24.5	(100)	23.9	26.1	(220)
EBIT	19.0	21.6	(260)	19.6	(60)	19.3	21.1	(180)
EBT	20.0	22.3	(240)	20.6	(60)	20.3	22.0	(170)
PAT	15.8	16.9	(110)	16.0	(20)	15.9	16.6	(70)
Effective Tax rate	20.5	24.1	(350)	21.7	(120)	21.1	24.0	(300)

Source: Company, BOBCAPS Research

Fig 2 – Operating metrics

(US\$ terms)	Q2FY22 (% Contr. to Revenue)	Growth	
		QoQ (%)	YoY (%)
Revenue by Business Segment			
Mode 1	60.9	1.6	7.1
Mode 2	25.8	11.7	37.4
Mode 3	13.3	(7.8)	(6.3)
Revenue by Geography			
US	62.8	2.1	10.8
Europe	28.3	4.1	10.9
Asia Pacific	8.9	1.5	16.6
Revenue by Service Offering			
IT and Business Services	72.6	4.0	14.2
Engineering and R&D Services	15.7	5.3	11.3
Products & Platforms	11.70	(8.4)	(3.5)
Revenues by Industry			
BFSI	21.3	(1.1)	7.3
Retail	9.8	0.5	4.9
Media, Publishing & Entertainment	7.9	2.6	14.2
Life Sciences	15.3	6.8	20.8
Energy Utilities -Public Sector	10.6	0.7	10.3
Manufacturing	17.9	6.8	12.6
Technology Services	17.2	2.0	10.7
Client Contribution to Revenue			
Top 5	12.7	0.2	8.2
Top 10	20.7	2.1	17.3
Top 20	29.9	0.9	15.0
Employee Metrics			
	Q2FY22	Q1FY22	Q2FY21
Total Employees	187,634	176,499	153,085
Net Addition	11,135	7,522	2,798
Attrition	15.7	11.8	12.2
Revenues by Contract Type (%)			
Time & material	35.4	33.5	32.6
Fixed Price	64.6	66.5	67.4

Source: Company, BOBCAPS Research

Valuation methodology

Following the Q2FY22 results, we lower our FY22/FY23/FY24 EPS estimates by 6%/7%/7% as we cut growth and margin assumptions to factor in a slowdown in the product business (11.7% of Q2 revenue). Our Sep'22 TP thus reduces to Rs 1,440 (vs. Rs 1,530), set at an unchanged one-year forward P/E multiple of 24.6x. Our target price pencils in HCLT's robust margin guidance for FY22 and its commitment to enhancing the Mode-2 and 3 portfolios (which command higher margins).

We reiterate BUY as we see relatively strong near-to-mid-term growth visibility for the company on the back of its growing Mode-2 software business (25.8% of revenue), healthy large-deal wins (14 contracts won in Q2FY22), and IMS heritage that offers unique positioning to leverage the cloud migration opportunity being accelerated by the pandemic.

Fig 3 – Revised estimates

(Rs mn)	New			Old			Change (%)		
	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E	FY22E	FY23E	FY24E
Revenues (US\$ mn)	11,317	12,464	13,639	11,489	12,682	13,996	(1.5)	(1.7)	(2.6)
YoY Growth (%)	11.2	10.1	9.4	12.9	10.4	10.4	-	-	-
Revenues	842,705	947,245	1,036,536	867,554	992,422	1,095,318	(2.9)	(4.6)	(5.4)
EBITDA	206,350	240,395	260,408	221,424	257,178	276,926	(6.8)	(6.5)	(6.0)
EBITDA margin (%)	24.5	25.4	25.1	25.5	25.9	25.3	-	-	-
EBIT margins (%)	19.8	20.2	20.2	20.8	20.9	20.6	-	-	-
Net profits	133,201	149,683	165,133	141,323	161,365	176,542	(5.7)	(7.2)	(6.5)
EPS (Rs)	49.1	55.2	60.9	52.1	59.5	65.1	(5.7)	(7.2)	(6.5)

Source: BOBCAPS Research

Fig 4 – Key assumptions

Parameter	FY21	FY22E	FY23E	FY24E
Services revenue (US\$ mn)	10,175	11,317	12,464	13,639
YoY Growth (%)	2.4	11.2	10.1	9.4
EBIT margin (%)	21.3	19.8	20.2	20.2

Source: Company, BOBCAPS Research

Fig 5 – Peer comparison

Ticker	Rating	Target Price (Rs)	US\$ Revenue CAGR FY21-23E (%)	EPS (Rs)		ROE (%)		Target P/E (x)
				FY22E	FY23E	FY22E	FY23E	
TCS IN	BUY	4,630	13.8	103.4	119.7	39.4	37.4	36.5
INFO IN	BUY	2,000	14.4	53.9	59.5	29.6	30.7	32.0
WPRO IN	BUY	840	18.4	23.4	26.9	21.2	21.6	28.8
HCLT IN	BUY	1,440	10.7	49.1	55.2	20.3	20.5	24.6
TECHM IN	BUY	1,660	14.1	66.8	78.1	21.9	22.7	27.8
LTI IN	BUY	6,780	19.3	132.1	159.7	29.1	29.6	39.5
MPLH IN	HOLD	3,530	16.0	79.7	93.2	21.9	23.7	35.0
MTCL IN	SELL	3,390	21.0	94.1	100.2	33.0	29.8	36.0
PSYS IN	HOLD	3,560	21.0	74.0	91.5	19.9	21.5	35.0
COFORGE IN	BUY	6,930	26.8	130.9	176.8	29.5	33.4	35.0

Source: BOBCAPS Research

Key risks

Key downside risks to our estimates are:

- above-expected revenue contraction in IMS due to automation,
- above-expected HCL Software client attrition,
- an inability to renew existing contracts, and
- adverse currency movement

Sector recommendation snapshot

Company	Ticker	Market Cap (US\$ bn)	Price (Rs)	Target (Rs)	Rating
Affle (India)	AFFLE IN	0.4	1,154	1,240	BUY
Coforge	COFORGE IN	4.6	5,604	6,930	BUY
eClerx Services	ECLX IN	1.2	2,300	2,880	BUY
HCL Technologies	HCLT IN	45.1	1,251	1,440	BUY
IndiaMart InterMesh	INMART IN	3.8	9,429	8,430	HOLD
Infosys	INFO IN	97.1	1,716	2,000	BUY
Just Dial	JUST IN	0.8	935	1,330	BUY
L&T Infotech	LTI IN	14.2	6,099	6,780	BUY
Mindtree	MTCL IN	10.3	4,691	3,390	SELL
Mphasis	MPHL IN	8.1	3,267	3,530	HOLD
Persistent Systems	PSYS IN	4.5	4,212	3,560	HOLD
Tata Consultancy Services	TCS IN	180.1	3,611	4,630	BUY
Tech Mahindra	TECHM IN	16.6	1,431	1,660	BUY
Wipro	WPRO IN	52.0	708	840	BUY

Source: BOBCAPS Research, NSE | Price as of 14 Oct 2021

Financials

Income Statement

Y/E 31 Mar (Rs mn)	FY20A	FY21A	FY22E	FY23E	FY24E
Total revenue	706,780	753,790	842,705	947,245	1,036,536
EBITDA	166,930	200,560	206,350	240,395	260,408
Depreciation	28,400	39,850	39,701	49,366	51,114
EBIT	138,530	160,710	166,649	191,029	209,294
Net interest inc./(exp.)	0	0	0	0	0
Other inc./(exp.)	1,790	6,580	5,464	5,923	7,986
Exceptional items	0	0	0	0	0
EBT	140,320	167,290	172,113	196,952	217,281
Income taxes	29,380	36,630	38,912	47,268	52,147
Extraordinary items	0	0	0	0	0
Min. int./Inc. from assoc.	0	0	0	0	0
Reported net profit	110,940	130,660	133,201	149,683	165,133
Adjustments	0	0	0	0	0
Adjusted net profit	110,940	130,660	133,201	149,683	165,133

Balance Sheet

Y/E 31 Mar (Rs mn)	FY20A	FY21A	FY22E	FY23E	FY24E
Accounts payables	0	0	0	0	0
Other current liabilities	259,090	217,050	294,947	331,536	362,788
Provisions	0	0	16,854	18,945	20,731
Debt funds	50,930	39,070	39,070	39,070	39,070
Other liabilities	5,280	5,850	5,850	5,850	5,850
Equity capital	2,812	2,812	2,812	2,812	2,812
Reserves & surplus	514,048	612,248	681,353	759,008	844,679
Shareholders' fund	522,140	620,910	690,015	767,670	853,341
Total liab. and equities	832,160	877,030	1,040,885	1,157,220	1,275,930
Cash and cash eq.	48,430	65,150	188,707	275,033	370,151
Accounts receivables	177,720	175,250	207,790	233,567	255,584
Inventories	0	0	0	0	0
Other current assets	79,030	74,290	84,270	94,724	103,654
Investments	105,680	140,220	168,264	185,090	203,599
Net fixed assets	62,440	62,450	41,365	10,998	(21,116)
CWIP	0	0	0	0	0
Intangible assets	294,210	291,500	291,500	291,500	291,500
Deferred tax assets, net	0	0	0	0	0
Other assets	64,650	68,170	58,989	66,307	72,558
Total assets	832,160	877,030	1,040,885	1,157,220	1,275,930

Cash Flows

Y/E 31 Mar (Rs mn)	FY20A	FY21A	FY22E	FY23E	FY24E
Cash flow from operations	143,665	78,334	228,849	188,258	204,102
Capital expenditures	(150,090)	(39,860)	(18,616)	(19,000)	(19,000)
Change in investments	47,160	34,540	28,044	16,826	18,509
Other investing cash flows	1,790	6,580	(50,625)	(27,730)	(29,032)
Cash flow from investing	(101,140)	1,260	(41,197)	(29,903)	(29,522)
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	0	0	0	0	0
Interest expenses	0	0	0	0	0
Dividends paid	(53,384)	(62,874)	(64,096)	(72,028)	(79,462)
Other financing cash flows	0	0	0	0	0
Cash flow from financing	(53,384)	(62,874)	(64,096)	(72,028)	(79,462)
Chg in cash & cash eq.	(10,859)	16,720	123,556	86,327	95,118
Closing cash & cash eq.	48,430	65,151	188,707	275,033	370,151

Per Share

Y/E 31 Mar (Rs)	FY20A	FY21A	FY22E	FY23E	FY24E
Reported EPS	40.9	48.1	49.1	55.2	60.9
Adjusted EPS	40.9	48.1	49.1	55.2	60.9
Dividend per share	16.4	19.3	19.6	22.1	24.3
Book value per share	192.4	228.8	254.3	282.9	314.5

Valuations Ratios

Y/E 31 Mar (x)	FY20A	FY21A	FY22E	FY23E	FY24E
EV/Sales	4.8	4.5	4.0	3.5	3.1
EV/EBITDA	20.2	16.9	16.4	13.8	12.3
Adjusted P/E	30.6	26.0	25.5	22.7	20.6
P/BV	6.5	5.5	4.9	4.4	4.0

DuPont Analysis

Y/E 31 Mar (%)	FY20A	FY21A	FY22E	FY23E	FY24E
Tax burden (Net profit/PBT)	79.1	78.1	77.4	76.0	76.0
Interest burden (PBT/EBIT)	101.3	104.1	103.3	103.1	103.8
EBIT margin (EBIT/Revenue)	19.6	21.3	19.8	20.2	20.2
Asset turnover (Rev./Avg TA)	99.5	88.2	87.9	86.2	85.2
Leverage (Avg TA/Avg Equity)	1.5	1.5	1.5	1.5	1.5
Adjusted ROAE	23.5	22.9	20.3	20.5	20.4

Ratio Analysis

Y/E 31 Mar	FY20A	FY21A	FY22E	FY23E	FY24E
YoY growth (%)					
Revenue	17.0	6.7	11.8	12.4	9.4
EBITDA	19.2	20.1	2.9	16.5	8.3
Adjusted EPS	11.5	17.8	1.9	12.4	10.3
Profitability & Return ratios (%)					
EBITDA margin	23.6	26.6	24.5	25.4	25.1
EBIT margin	19.6	21.3	19.8	20.2	20.2
Adjusted profit margin	15.7	17.3	15.8	15.8	15.9
Adjusted ROAE	23.5	22.9	20.3	20.5	20.4
ROCE	23.4	22.2	22.5	26.8	29.9
Working capital days (days)					
Receivables	84	85	83	85	86
Inventory	0	0	0	0	0
Payables	130	157	147	162	163
Ratios (x)					
Gross asset turnover	7.3	12.1	16.2	36.2	(204.9)
Current ratio	1.4	1.8	1.7	1.9	2.1
Net interest coverage ratio	NA	NA	NA	NA	NA
Adjusted debt/equity	0.0	0.0	(0.2)	(0.3)	(0.4)

Source: Company, BOBCAPS Research | Note: TA = Total Assets

Disclaimer

Recommendation scale: Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

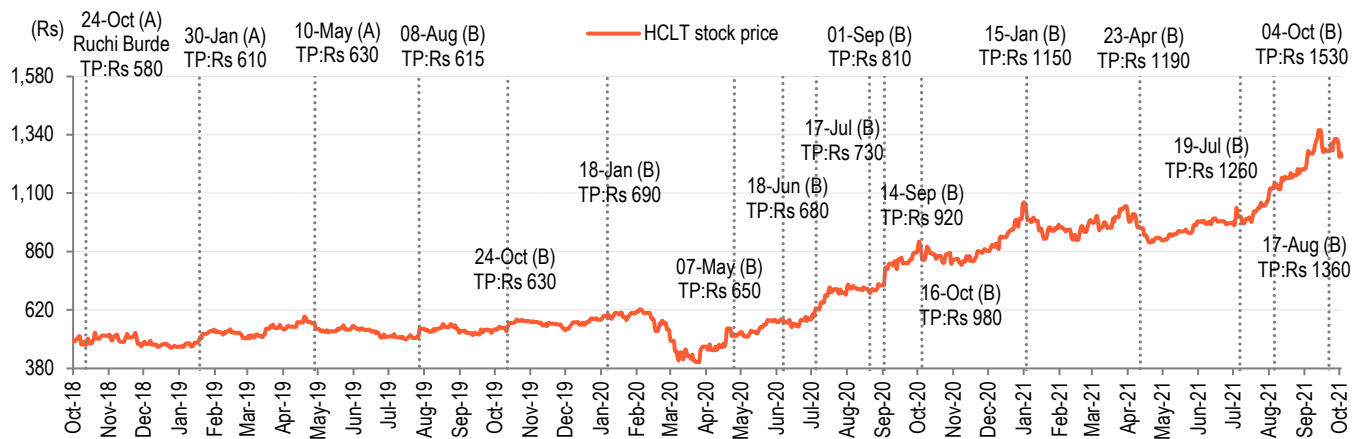
HOLD – Expected return from -6% to +15%

SELL – Expected return <-6%

Note: Recommendation structure changed with effect from 21 June 2021

Our recommendation scale does not factor in short-term stock price volatility related to market fluctuations. Thus, our recommendations may not always be strictly in line with the recommendation scale as shown above.

Ratings and Target Price (3-year history): HCL TECHNOLOGIES (HCLT IN)



B – Buy, H – Hold, S – Sell, A – Add, R – Reduce

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