

Sector: IT & ITES
Company update

	Change
Reco: Buy	↔
CMP: Rs. 1,056	
Price Target: Rs. 1,250	↔

↑ Upgrade ↔ No change ↓ Downgrade

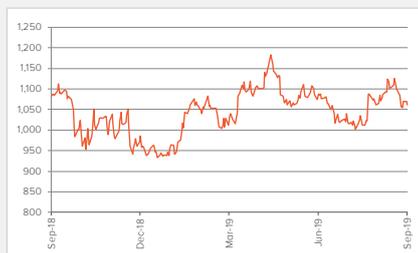
Company details

Market cap:	Rs. 143,273 cr
52-week high/low:	Rs. 1,190 / 920
NSE volume: (No of shares)	18.8 lakh
BSE code:	532281
NSE code:	HCLTECH
Sharekhan code:	HCLTECH
Free float: (No of shares)	54.2 cr

Shareholding (%)

Promoters	60.0
FII	29.1
DII	8.2
Others	2.7

Price chart



Price performance

(%)	1m	3m	6m	12m
Absolute	0.7	-1.4	4.3	0.7
Relative to Sensex	1.3	4.2	6.0	2.0

Sharekhan Research, Bloomberg

We spoke to the management of HCL Technologies (HCL Tech) to get an update on demand environment, impact from troubled clients, and pace of investments in digital and margin trajectory. Management's commentary remained broadly similar to Q1FY2020, as it has not seen any material changes in the business environment yet, owing to macro uncertainties. Excluding the impact of two troubled client accounts, HCL Tech is expected to maintain its growth momentum across verticals in the remaining quarters of FY2020E. With revenue contribution from the acquisition of IBM products, which have higher margins, from Q2FY2020E, EBIT margin is expected to improve in Q2/Q3 despite wage revision (impact would be similar to Q2/Q3 in FY2019). Ramp-up of large deals won in recent quarters, opportunities in IMS segment, and strong growth in ERS business are expected to support organic growth in the coming quarters. Hence, we believe HCL Tech has the potential to deliver revenue growth at the upper end of its guidance range of 14-16% in FY2020E.

Digital gains traction; Focus remains on products and platforms: HCL Tech's digital offering has started gaining traction among customers (grew 38.3% y-o-y in Q1FY2020) given its aggressive investments in building digital competencies through in-house and acquisitions, though HCL Tech's digital contribution to revenue remains lower compared to peers. Higher investments in its digital business are expected to continue for the next couple of years, which may have an impact on margins. Management also indicated that the company will focus on expanding its product portfolio with incremental investments, including the inorganic route.

Our Call

Valuation – Maintain Buy: HCL Tech is expected to deliver strong organic growth among large peers in FY2020E, led by robust organic growth (14% y-o-y CC) in Q1FY2020, large addressable opportunity in IMS, and strong growth in the ERS business. Further, investments in digital technology would help the company build digital competencies, which would provide a sustainable growth momentum going forward. However, we believe aggressive capital allocation towards the product business remains a risk to its business model and the integration of recent acquisitions remain a primary focus area. At the CMP, the stock trades at 14x/13x its FY2020E/FY2021E earnings estimates, which look attractive and is at a discount to peers despite better revenue growth. We maintain our Buy rating on the stock with an unchanged PT of Rs. 1,250.

Key Risks

Any integration issues in ongoing M&A activities, especially IP-related transactions, could impact earnings. Further, high dependence on IMS could create challenges to its revenue growth trajectory.

Particulars	Rs cr				
	FY17	FY18	FY19	FY20E	FY21E
Revenue	46,722.0	50,570.0	60,427.0	69,502.0	76,642.8
OPM (%)	22.1	22.6	23.1	22.8	22.9
Adjusted PAT	8,456.0	8,780.0	10,123.0	10,118.7	11,207.7
% YoY growth	15.0	3.8	15.3	0.0	10.8
Adjusted EPS (Rs.)	60.7	62.6	73.6	74.6	82.6
P/E (x)	17.5	17.0	14.4	14.2	12.9
P/B (x)	4.6	4.2	3.7	3.1	2.8
EV/EBITDA (x)	14.6	12.6	10.3	9.1	8.2
RoNW (%)	27.9	25.3	26.0	23.0	22.8
RoCE (%)	31.5	30.0	29.2	26.0	25.7

Source: Company; Sharekhan Research

Witnessed no material change in business environment

Management of HCL Tech highlighted that it has not seen any material changes in the business environment post Q1FY2020 commentary or holding back of tech spending from clients. Management remains cautiously optimistic on the demand environment in the near-to-medium term, given ongoing macro uncertainties, including slowdown in GDP growth, trade war, and Brexit. In Q1FY2020, management had highlighted two client-specific issues, one each in the BFSI and manufacturing verticals. Except these two accounts, management has not seen any issues in any other accounts and remains positive on the demand outlook in other verticals. Despite slowdown in the BFSI vertical, HCL Tech's management remains optimistic on growth momentum in this vertical (excluding the troubled account), given new logo wins in this vertical during the quarter.

Expect to meet the top-end of its revenue growth guidance band

Despite delay in closure of acquisition of select products of IBM by one month, the company has retained its revenue growth guidance of 14-16% for FY2020E, while increasing its organic revenue growth guidance band to 8-10% from 7-9% due to strong organic growth in 1QFY2020. The faster ramp-up of large deals won in the second half of FY2019 and softer ramp-down from a couple of financial services and one manufacturing client helped to outperform in organic growth in Q1FY2020. Management reiterated that revenue from one of the two troubled financial clients has normalised. Further, sustained deal momentum, opportunities in the IMS segment (rising adoption of hybrid cloud and digital work place), and strong growth momentum in the ERS business would support organic growth going forward. With revenue contribution from the IBM product acquisition and anticipation of acceleration of organic growth in the remaining quarters of FY2019, we believe HCL Tech has the potential to achieve the upper end of the guidance range. Notably, management highlighted that the guidance has enough cushion to meet any potential slowdown owing to volatility in the external environment.

EBIT margin to recover in Q2FY2020E and remain in the targeted range in FY2020E

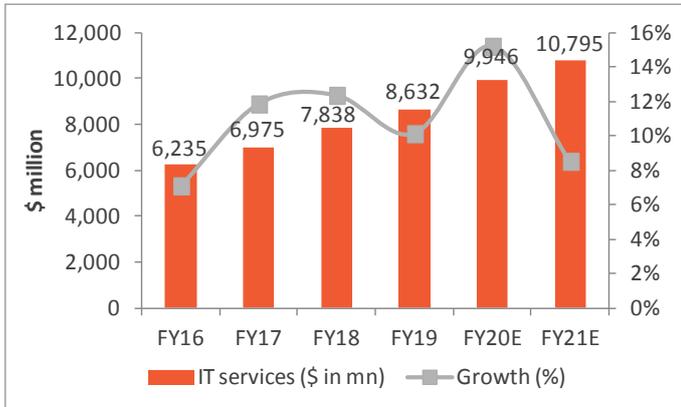
We expect HCL Tech to comfortably achieve the targeted margin band of 18.5-19.5% in FY2020E despite weak start at 17.1% to the year (in Q1FY2020). Margin was impacted due to upfront investments to integrate acquisition of select IBM products and decline in ERS business profitability. With revenue contribution from acquisition of IBM products, which have higher margins, EBIT margin would improve significantly in Q2FY2020E/Q3FY2020E despite wage revision (impact would be similar to FY2019, around 40 BPS in Q2FY2020E and 70 BPS in Q3FY2020E). EBIT margin is expected to remain strong in Q3FY2020E on account strong seasonality of product business, though HCL Tech's Mode-3 revenue growth and margins in Q3FY2019 have not remained the highest in FY2019.

Higher investments in building digital competencies to continue

HCL Tech focuses on a strategy that leverages its core strength in product engineering services and IT services to build next-generation products and services. Apart from focusing on building in-house digital competencies, HCL Tech has completed few acquisitions to fill the gap of its digital capabilities. HCL Tech's digital business (Mode-2) revenue contribution to total revenue remains lower compared to its peers, though y-o-y growth of its digital business remained strong at 38.3% in Q1FY2020. To create a sustainable growth engine, the company has been investing aggressively in digital competencies, which may impact margins. Management indicated that higher investments in its digital business should continue for the next few years and margins should improve once Mode-2 business scaled up.

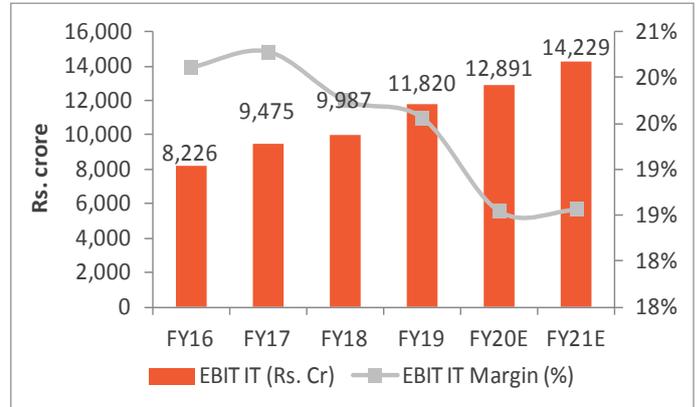
Financials in charts

Revenue in US\$ (mn) and growth (%)



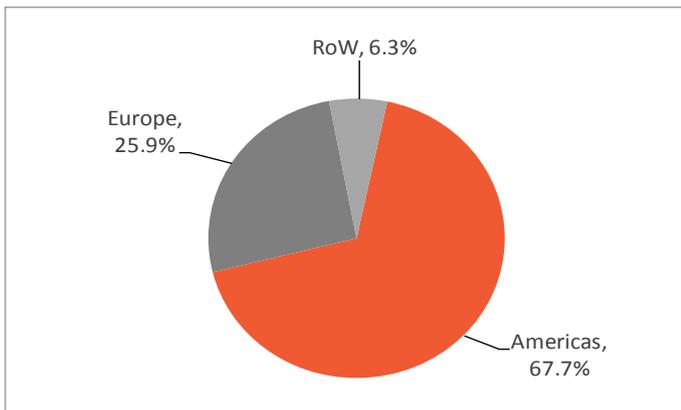
Source: Company, Sharekhan Research

EBIT (Rs. cr) and EBIT margin (%)



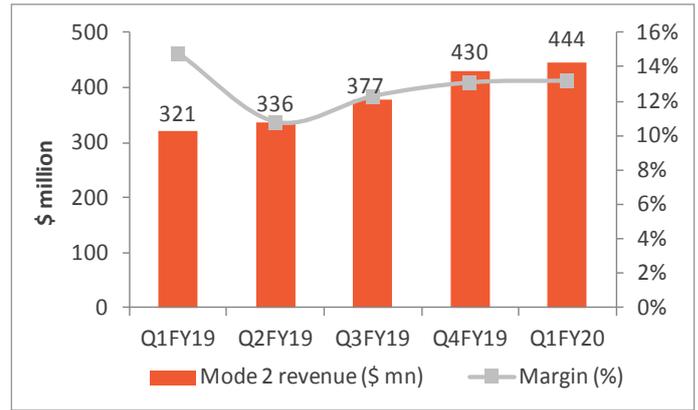
Source: Company, Sharekhan Research

Geography break-up



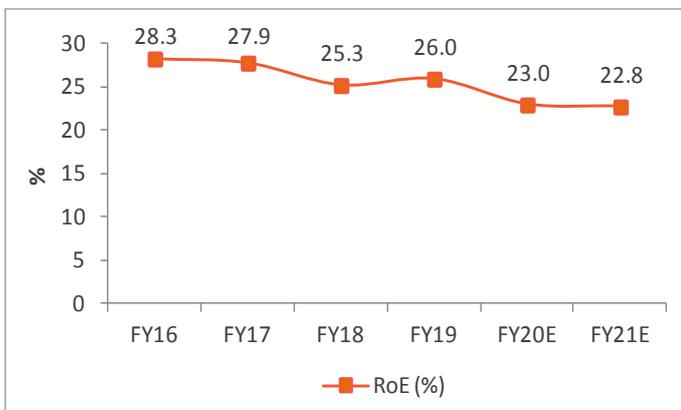
Source: Company, Sharekhan Research

Mode 2 revenue (incl. digital) and margin (%)



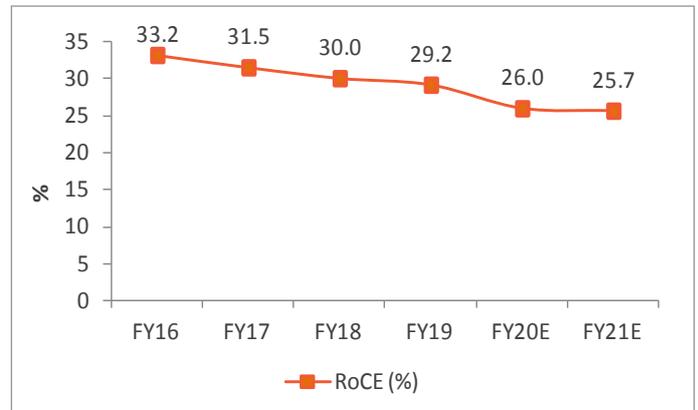
Source: Company, Sharekhan Research

RoE trend



Source: Company, Sharekhan Research

RoCE trend



Source: Company, Sharekhan Research

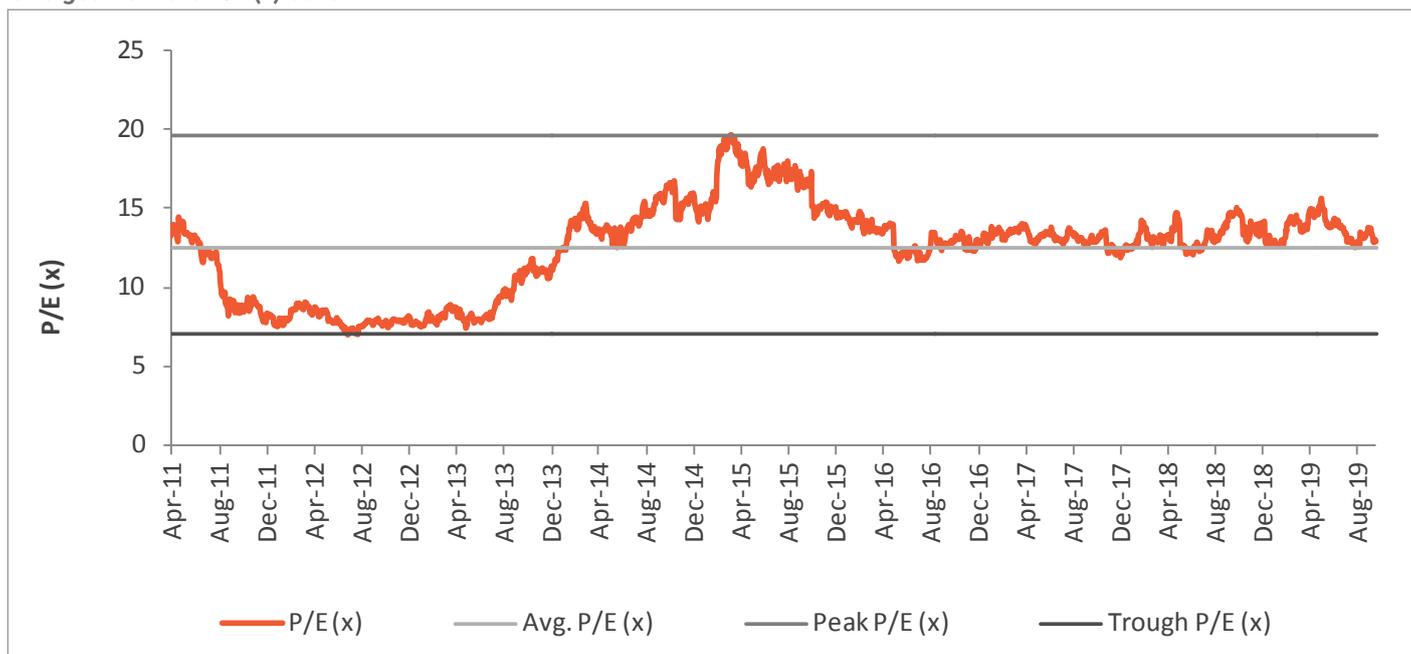
Outlook

Growth for Indian IT is expected to accelerate from 6-7% currently, as demand for digital services grows rapidly. India will continue to remain the preferred destination for talent supply and create a gradual shift of digital business from onsite. HCL Tech has invested aggressively in the fast-growing Mode-2 (a good proxy for digital offering) capabilities to create a sustainable growth engine going forward. Further, the company has placed large investments in acquiring IP products to diversify its focus on new high-margin revenue streams. The addressable market opportunity for IMS is very large, with only 10-12% penetration of the addressable market. Given its differentiated positioning in IMS and strong capabilities in engineering services, HCL Tech is well positioned to maintain its growth momentum in these segments going ahead.

Valuation

HCL Tech is expected to deliver strong organic growth among large peers in FY2020E, led by robust organic growth (14% y-o-y CC) in Q1FY2020, large addressable opportunity in IMS, and strong growth in ERS business. Further, investments in digital technology would help the company build digital competencies, which would provide a sustainable growth momentum going forward. However, we believe aggressive capital allocation towards the product business remains a risk to its business model and integration of recent acquisitions remains the primary focus area. At the CMP, the stock trades at 13x/12x its FY2020E/FY2021E earnings estimates, which looks attractive and is at a discount to peers despite better revenue growth. We maintain our Buy rating on the stock with an unchanged PT of Rs. 1,250.

One-year forward P/E (x) band



Source: Sharekhan Research

Peer valuation

Particulars	CMP (Rs / Share)	O/S Shares (Cr)	MCAP (Rs Cr)	P/E (x)		EV/EBIDTA (x)		P/BV (x)		RoE (%)	
				FY20E	FY21E	FY20E	FY21E	FY20E	FY21E	FY20E	FY21E
HCL Tech	1,056	136	1,47,273	14.2	12.9	9.1	8.2	3.1	2.8	23.0	22.8
Infosys	831	430	3,56,918	21.5	19.0	15.0	13.3	3.0	2.9	25.6	29.0
TCS	2,121	375	7,95,881	23.6	21.5	17.7	15.9	8.0	7.2	35.6	35.4
Tech M	706	96	68,083	14.7	12.6	9.4	7.6	3.0	2.7	19.3	19.8
Wipro	244	603	1,47,228	14.9	13.4	9.5	8.2	3.0	2.7	17.9	18.1

Source: Company, Sharekhan Research

About company

HCL Tech is a leading global technology company providing software-led IT solutions, remote infrastructure management, and 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 large deal wins, gradual recovery in IMS, and focus on products business. Further, 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.

Key Risks

- ◆ Continued slowdown in organic revenue growth;
- ◆ Integration issues in ongoing M&A activities, especially IP-related transactions;
- ◆ Rupee appreciation and/or adverse cross-currency movements;
- ◆ Pressure in renewal of IMS deals;
- ◆ Any hostile regulatory visa norms could have an impact on employee expenses;
- ◆ Any major macro issues in developed markets, especially in the U.S. and Europe.

Additional Data

Key management personnel

Shiv Nadar	Founder & Chairman
C Vijay Kumar	President & CEO
Prateek Aggarwal	Chief Financial Officer
G H Rao	President - Engineering and R&D Services
Rahul Singh	President – Financial Services

Source: Company

Top 10 shareholders

Sr. No.	Holder Name	Holding (%)
1	Vama Sundari Investments Delhi Pvt	42.9
2	HCL Holdings Pvt Ltd	16.5
3	BlackRock Inc	1.7
4	Artisan Partners LP	1.5
5	Vanguard Group Inc/The	1.4
6	ICICI Prudential Asset Management	1.2
7	SBI Funds Management Pvt Ltd	1.1
8	Life Insurance Corp of India	1.1
9	Nomura Holdings Inc	0.9
10	Vontobel Holding AG	0.9

Source: Bloomberg

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