

## Company

1 September 2010 | 8 pages

# HCL Technologies (HCLT.BO)

Equity   
Target price change   
Estimate change

## NDR Takeaways – BPO Investments to Impact Near Term Margins

- Management NDR** — We hosted HCLT management for an NDR in Mumbai over August 30-31. Company was represented by Sanjiv Nikore (Head – Retail, CPG and Manufacturing), G. H. Rao (Head – Engineering and R&D services), Sandip Gupta (Dy. CFO) and Sanjay Mendiratta (Head – IR).
- Demand strong; Pipeline reasonable** — Economic environment looks stable and companies are spending on initiatives that keep them competitive. Discretionary spends should continue to be there – it may moderate from the surge seen, but unlikely to scale down sharply. Management has not seen any decline in pipeline, which would have been the case if clients would have cut back on spends.
- Margin decline of ~250bps yoy in FY11** — Management expects a margin decline of ~300bps in Q1FY11. The margins should then recover over the next few quarters with the Q4FY11 at the same level as Q4FY10 (EBIT: 15.3% ex forex losses). For FY11, margins are expected to be ~250bps lower than FY10 due to wage hikes and higher than expected investments in BPO business.
- BPO to continue in investment mode** — Management indicated that BPO is likely to be in investment mode over the next 5-6 quarters and quarterly losses over next 6 quarters could be similar/slightly higher than the loss reported in Q4FY10 (~\$6.5m). While this is higher than our earlier expectations, we believe BPO is an important part of the longer term strategy of HCLT and needs to be fixed.
- Margins a near term dampener but long term thesis intact** — We have incorporated management guidance of BPO losses, ESOP and tax charges in our model. Our estimates decline by ~4% for FY11 while it is largely unchanged over FY12-13E. Our new target price of Rs480 (from Rs495) remains based on 18x Dec'11 EPS. Near term margin issues are a dampener, but the longer term thesis holds. With a significant discount of ~30% to Infosys/TCS, we remain Buyers.

<b>Buy/Low Risk</b>	<b>1L</b>
Price (31 Aug 10)	Rs383.55
Target price	Rs480.00
	<i>from Rs495.00</i>
Expected share price return	25.1%
Expected dividend yield	1.0%
<b>Expected total return</b>	<b>26.2%</b>
Market Cap	Rs260,580M
	US\$5,537M

### Price Performance (RIC: HCLT.BO, BB: HCLT IN)



### Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
30 Jun	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2009A	11,788	17.48	15.3	21.9	4.5	21.6	1.8
2010A	12,152	17.62	0.8	21.8	3.7	19.1	1.0
2011E	16,038	23.17	31.5	16.6	3.1	20.7	1.0
2012E	21,053	30.42	31.3	12.6	2.5	22.3	1.6
2013E	25,704	37.14	22.1	10.3	2.0	22.2	1.6

Source: Powered by dataCentral

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Fiscal year end 30-Jun	2009	2010	2011E	2012E	2013E
<b>Valuation Ratios</b>					
P/E adjusted (x)	21.9	21.8	16.6	12.6	10.3
EV/EBITDA adjusted (x)	11.0	10.4	9.4	7.0	5.4
P/BV (x)	4.5	3.7	3.1	2.5	2.0
Dividend yield (%)	1.8	1.0	1.0	1.6	1.6
<b>Per Share Data (Rs)</b>					
EPS adjusted	17.48	17.62	23.17	30.42	37.14
EPS reported	17.48	17.62	23.17	30.42	37.14
BVPS	85.11	104.43	125.46	153.33	188.06
DPS	7.00	4.00	4.00	6.00	6.00
<b>Profit &amp; Loss (RsM)</b>					
Net sales	106,084	125,650	153,744	181,388	211,994
Operating expenses	-88,106	-105,805	-132,233	-153,723	-179,190
<b>EBIT</b>	<b>17,978</b>	<b>19,846</b>	<b>21,511</b>	<b>27,665</b>	<b>32,804</b>
Net interest expense	-3,674	-5,302	-1,234	642	1,847
Non-operating/exceptionals	27	12	0	0	0
<b>Pre-tax profit</b>	<b>14,331</b>	<b>14,556</b>	<b>20,276</b>	<b>28,307</b>	<b>34,651</b>
Tax	-2,543	-2,404	-4,238	-7,254	-8,947
Extraord./Min.Int./Pref.div.	0	0	0	0	0
<b>Reported net income</b>	<b>11,788</b>	<b>12,152</b>	<b>16,038</b>	<b>21,053</b>	<b>25,704</b>
Adjusted earnings	11,788	12,152	16,038	21,053	25,704
Adjusted EBITDA	22,471	24,855	26,277	33,158	39,284
<b>Growth Rates (%)</b>					
Sales	38.9	18.4	22.4	18.0	16.9
EBIT adjusted	38.5	10.4	8.4	28.6	18.6
EBITDA adjusted	40.3	10.6	5.7	26.2	18.5
EPS adjusted	15.3	0.8	31.5	31.3	22.1
<b>Cash Flow (RsM)</b>					
<b>Operating cash flow</b>	<b>20,356</b>	<b>19,558</b>	<b>20,584</b>	<b>24,325</b>	<b>28,949</b>
Depreciation/amortization	4,493	5,009	4,766	5,493	6,480
Net working capital	401	-2,905	675	551	743
<b>Investing cash flow</b>	<b>-44,917</b>	<b>-7,047</b>	<b>-7,216</b>	<b>-8,016</b>	<b>-8,816</b>
Capital expenditure	-7,038	-7,633	-7,216	-8,016	-8,816
Acquisitions/disposals	-35,740	2,203	0	0	0
<b>Financing cash flow</b>	<b>18,166</b>	<b>-7,957</b>	<b>-1,298</b>	<b>112</b>	<b>1,317</b>
Borrowings	29,771	-3,139	0	0	0
Dividends paid	-5,470	-3,154	-3,169	-4,754	-4,754
<b>Change in cash</b>	<b>-6,395</b>	<b>4,554</b>	<b>12,070</b>	<b>16,421</b>	<b>21,450</b>
<b>Balance Sheet (RsM)</b>					
<b>Total assets</b>	<b>126,942</b>	<b>135,715</b>	<b>156,771</b>	<b>182,629</b>	<b>213,742</b>
Cash & cash equivalent	18,995	24,419	37,229	54,130	76,060
Accounts receivable	27,083	30,496	36,293	42,728	49,574
Net fixed assets	15,862	18,486	20,936	23,458	25,794
<b>Total liabilities</b>	<b>70,080</b>	<b>65,347</b>	<b>71,819</b>	<b>78,805</b>	<b>86,394</b>
Accounts payable	32,675	31,329	37,801	44,787	52,376
Total Debt	29,771	26,632	26,632	26,632	26,632
<b>Shareholders' funds</b>	<b>56,859</b>	<b>70,368</b>	<b>84,952</b>	<b>103,824</b>	<b>127,348</b>
<b>Profitability/Solvency Ratios (%)</b>					
EBITDA margin adjusted	21.2	19.8	17.1	18.3	18.5
ROE adjusted	21.6	19.1	20.7	22.3	22.2
ROIC adjusted	32.6	25.7	24.5	28.2	32.2
Net debt to equity	19.0	3.1	-12.5	-26.5	-38.8
Total debt to capital	34.4	27.5	23.9	20.4	17.3

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## Estimate Changes

Figure 1. Estimate change table

FYE	Net Profit (RsM)	EPS (Rs)	% chg	DPS (Rs)
30 Jun				
2011E	16,038	23.17	-3.9	4.00
Prev	16,697	24.12		6.00
2012E	21,053	30.42	-0.6	6.00
Prev	21,172	30.59		6.00
2013E	25,704	37.14	0.0	6.00
Prev	25,705	37.14		6.00

Source: Citi Investment Research and Analysis estimates

## PE Band Chart

Figure 2. PE band chart



Source: Citi Investment Research and Analysis

## Valuation Comparison

Figure 3. Indian IT Services – valuation comparison table

Company Name	RIC Code	CIR Rating	MCap (\$m)	CMP (Rs)	TP (Rs)	P/E (x)		EV/EBITDA (x)		EV/Sales(x)	
						FY11E	FY12E	FY11E	FY12E	FY11E	FY12E
Infosys	INFY.BO	2L	32,847	2,707	3,065	22.0	18.7	15.9	13.4	5.3	4.5
TCS	TCS.BO	2L	35,092	844	930	20.6	18.5	16.0	14.2	4.6	3.9
Wipro	WIPR.BO	1L	20,816	400	490	17.9	15.9	13.6	11.4	3.0	2.5
HCL Tech	HCLT.BO	1L	5,537	384	480	16.6	12.6	10.0	7.9	1.7	1.4

Source: Citi Investment Research and Analysis

## HCL Technologies

### Company description

HCL Technologies (HCLT) is the fifth-largest Indian IT services company. Founded in 1991, HCLT focused on technology and R&D outsourcing before diversifying into enterprise applications. In the infrastructure business, it has been gradually shifting focus from domestic sales to global services. In BPO, it boasts strong ties with British Telecom. The company leverages off its extensive offshore infrastructure and its global network to deliver solutions across verticals including Banking, Insurance, Retail, Consumer, Aerospace, Automotive, Semiconductors, Telecom and Life Sciences. HCLT has more than 400 clients across verticals and a workforce of ~65,000.

### Investment strategy

We rate HCLT shares Buy/Low Risk (1L). HCLT has been at the forefront of pursuing large deals, announcing ~\$3.5bn of large deals in FY09-10. A significant presence across IT services, BPO services and IMS has helped HCLT qualify for multi-year outsourcing deals. IMS, R&D and BPO service offerings should enable it to post strong revenue growth, although BPO could be impacted in the near term as the company tries to restructure it. The Axon acquisition helps HCLT in filling up the gap in Enterprise Services, where HCLT was lagging its peers. With ERP showing signs of recovery, we expect Axon to start contributing to growth in the coming quarters. We forecast ~22% revenue (\$ terms) and ~28% EPS CAGRs over FY10-13E.

### Valuation

Our target price is Rs480 based on 18x Dec'11E EPS. This is higher than the mid-point of the 6-23x band that the stock has traded in over the past three years. We believe a higher multiple is justified given improving macro and potential benefits arising out of the Axon acquisition. We believe PE remains the most appropriate valuation measure given HCLT's profitable track record.

### Risks

We rate HCLT shares Low Risk which is inline with our quantitative risk-rating system as the company has significant scale, enjoys a good brand name and continues to generate significant FCF. Key downside risks that could impede the stock from reaching our target price include: (1) any significant appreciation of the rupee against the USD/EUR/GBP; (2) a sharp slowdown in the US/Global economy; (3) acquisition-related risks; and (4) the strategy of pursuing large deals could have negative margin implications.

# Appendix A-1

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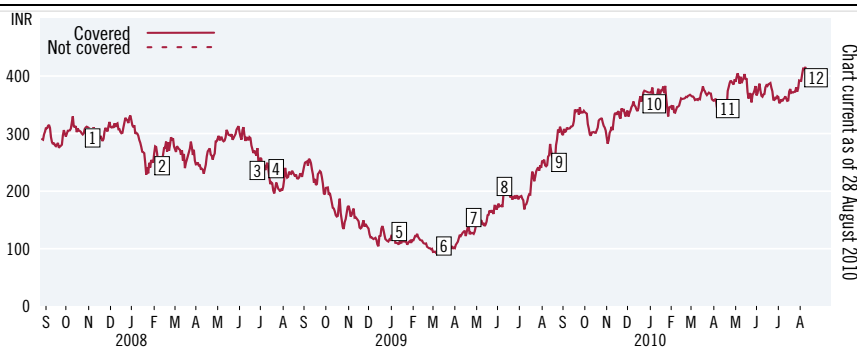


Chart current as of 28 August 2010

	Date	Rating	Target Price	Closing Price
1	7-Nov-07	1M	*365.00	295.35
2	13-Feb-08	1M	*340.00	251.45
3	26-Jun-08	1M	*350.00	274.80
4	23-Jul-08	1M	*245.00	214.95

\* Indicates change

	Date	Rating	Target Price	Closing Price
5	13-Jan-09	*2H	*120.00	108.60
6	17-Mar-09	2H	*111.00	101.15
7	28-Apr-09	*2M	*140.00	125.85
8	10-Jun-09	2M	*215.00	204.40

	Date	Rating	Target Price	Closing Price
9	26-Aug-09	2M	*345.00	301.55
10	7-Jan-10	2M	*435.00	360.50
11	21-Apr-10	*1M	435.00	374.10
12	24-Aug-10	*1L	*495.00	408.50

Rating/target price changes above reflect Eastern Standard Time

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