HCL TECHNOLOGIES

INR 639

Fructifying large deals

BUY

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HCL Technologies Q2FY07 results were ahead of expectations. Revenue grew 6.2% Q-o-Q and 39.0% Y-o-Y. The net profit, which shows a growth of 14.4% Q-o-Q and 58.1% Y-o-Y, does not take into account the ESOP and restricted stock units (RSU) charges. After providing for those charges, the net profit grew by 12.9% Q-o-Q and 57.2% Y-o-Y, which is also encouraging. EBITDA margin increased by 40bps, contributed by higher billing rates and improved utilisation. The company once again witnessed double digit Q-o-Q revenue growth (up 12.5%) in the fast-growing infrastructure segment. HCL reported strong growth from top 11-20 accounts (up 13.5% Q-o-Q), indicating the strong traction and the potential in the other than top 10 accounts. Also, with 45 clients under multi-service delivery deals, we see huge potential for HCL Tech to gain higher share of these clients' total spending.

We have revised our FY07 and FY08 estimates to take into account higher-than-expected ESOP and RSU charges that the company will be taking into its financials. This has led to a downward revision in the EPS by 6.9% to INR 31.3 and by 5.4% to INR 38.6, for FY07E and FY08E, respectively. At CMP of INR 639, the stock trades at a P/E of 20.4x and 16.6x for our FY07E and FY08E revised earnings, respectively. We maintain our 'BUY' recommendation.

Key highlights

- Revenue at INR 14.7 bn grew by 6.2% Q-o-Q and 39.0% Y-o-Y. Net profit was at INR 2.9 bn, up by 14.4% Q-o-Q and 58.0% Y-o-Y. The reported net profits do not take into account the restricted stock units (RSUs) and ESOP charges accounting for INR 266 mn. Adjusting for that, the net profit grew by 12.9% Q-o-Q and 57.2% Y-o-Y.
- The EBITDA margin improved by 40bps Q-o-Q. Improvement in billing rates, utilization and higher proportion of offshore revenues contributed to the margin expansion. During the period, the company faced margin pressures from factors such as adverse exchange rates and higher SG&A spends. These were, however, mitigated by the above mentioned positive factors.
- Offshore utilization was at 69.4%, up by 150bps Q-o-Q. Onsite utilization was at 95.2%, up 300bps.
- Offshore revenues accounted for 49% of total revenues, compared to 48.2% in the previous quarter.

Financials

Year to June	Q2FY07	Q1FY07	*Growth %*	Q2FY06	*Growth %*	FY07E	FY08E
Revenue (INR mn)	14,651	13,795	*6.2*	10,542	*39.0*	60,833	76,654
Gross profit (INR mn)	5,544	5,087	*9.0*	3,978	*39.4*	22,725	28,669
EBITDA (INR mn)	3,241	2,989	*8.4*	2,377	*36.3*	13,384	17,477
Net profit (INR mn)	2,597	2,300	*12.9*	1,651	*57.3*	10,189	12,650
Adj. EPS basic (INR)	8.8	7.7	*14.3*	5.6	*56.7*	31.3	38.6
P/E (x)						20.4	16.6
EV/EBITDA (x)						14.9	11.1
Mkt cap / Rev. (x)						3.4	2.7

Reuters	:	HCLT.BO
Bloomberg	:	HCLT IN

Market Data

52-week range (INR)	:	707 / 362
Share in issue (mn)	:	324.4
M cap (INR bn/USD mn)	:	207.3 / 4,681.7
Avg. Daily Vol. BSE/NSE ('000)	:	621.1

Share Holding Pattern (%)

Promoters	:	69.0
MFs, FIs & Banks	:	7.5
FIIs	:	16.3
Others	:	7.2

Edelweiss Research is also available on Bloomberg EDEL <GO>, Thomson First Call, Reuters and Factset.

- During the quarter, the company added 23 new clients, taking its active client base to 230.
- The number of clients contributing revenues of USD 1 mn plus now stands at 145, compared to 143 in the previous quarter and 130 in the corresponding quarter last year. Clients contributing revenues of over USD 50 mn have increased to three from two in the previous quarter.
- HCL Tech added 1,865 employees (net) for the quarter, taking the total headcount to 38,317. The attrition for the quarter (excl. BPO) was at 17.7%, up from 16.1% in the previous quarter.

Segmental comments

IT services

- Revenues at INR 10.7 bn were up 5.2% Q-o-Q and 34.2% Y-o-Y, contributing 73.3% to total revenues during the quarter.
- EBIT for this segment stood at INR 2.1 bn. EBIT margin improved by 30bps to 19.5%, compared to 19.2% in the previous quarter.

Infrastructure management services (IMS)

- Revenues at INR 2.1 bn were up 12.5% Q-o-Q and 70.8% Y-o-Y, contributing 14% to total revenues during the quarter.
- EBIT for this segment stood at INR 245 mn. EBIT margin improved further to 11.9% from 11.7% in the previous quarter.

BPO services

- Revenues at INR 1.9 bn were up 5.4% Q-o-Q and 38.8% Y-o-Y, contributing 12.7% to total revenues during the quarter.
- EBIT for this segment stood at INR 275 mn. EBIT margin improved by 20bps in the current quarter to 14.8%.

Margin enhancing deals

Over the past 18 months, HCL Tech has won six multi-year, multi-service and multi-million dollar deals. Revenues from such deals accounted for 10% of total in the current quarter. Surprisingly, the company stated that, these revenues were margin enhancing rather than margin diluting, even at the early stage of scale up on these deals. We believe that two of the deals are in a steady state as in the previous quarters, some are in the scale up stage, while others are in the transition phase (onsite to offshore). While there were concerns that pursuance of large deals would suppress margins, the ramp up of these deals has not only provided a cushion, but has also enhanced the overall margin. We also note that deals worth USD 5 bn are expected to be unbundled in the next twelve months, which will be up for grabs. We expect HCL Tech to demonstrate higher consistency enabled by strong order book and good track record in winning such large deals.

Table 1: Margins across business segments

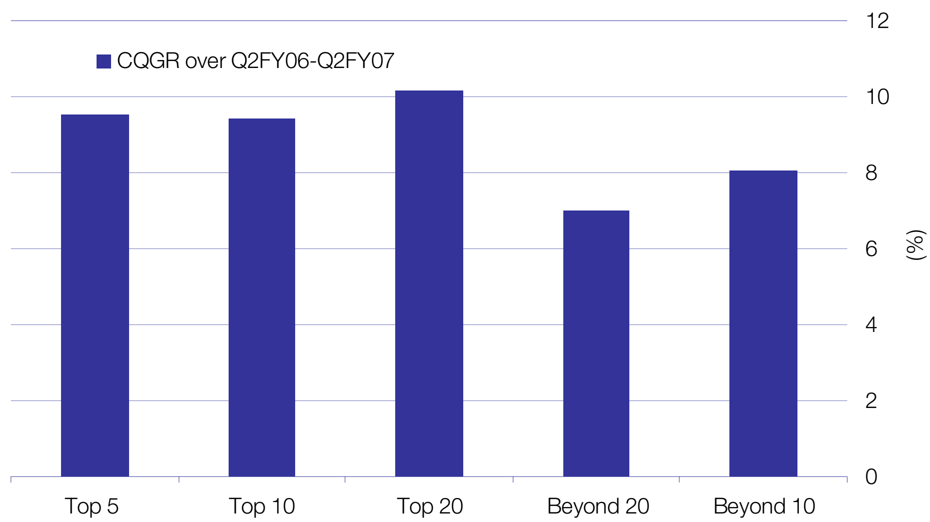
Year end June	Q4FY05	Q1FY06	Q2FY06	Q3FY06	Q4FY06	Q1FY07	Q2FY07
Gross margins (%)							
IT services	37.8	37.6	38.0	39.3	37.4	37.6	39.1
Infrastructure Mgmt Svcs	32.5	33.1	32.4	32.2	34.3	34.2	32.6
BPO Svcs	41.8	38.5	40.8	34.7	34.6	35.1	36.4
EBITDA margins (%)							
IT services	23.1	22.8	22.9	23.5	23.2	22.3	22.9
Infrastructure Mgmt Svcs	11.4	12.6	15.0	15.4	17.4	17.6	17.5
BPO Svcs	28.7	26.3	27.2	21.5	22.8	22.4	22.9
EBIT margins (%)							
IT services	18.9	19.0	19.2	19.8	19.8	19.2	19.5
Infrastructure Mgmt Svcs	5.9	6.6	7.7	7.7	10.5	11.7	11.9
BPO Svcs	19.8	18.0	18.7	13.6	15.0	14.6	14.8

Source: Company

Strong momentum continues in the top 20 accounts

The company has, over the past year, added large accounts, which currently are at the ramp up phase. The number of clients contributing revenues greater than USD 5 mn now stands at 46 compared to 33 a year ago. The realization per top 20 customers has grown at an impressive 10.2% CQGR over the past four quarters.

Chart 1: Revenue CQGR for various clients categories



Source: Company, Edelweiss research

Change in estimates

We have revised our FY07 and FY08 estimates to take into account the current quarter performance and also the charge on account of the employee stock options. The management stated that the charge pertaining to the ESOP and RSUs will be USD 6 mn plus each quarter, which is higher than our estimate. Thus, our EPS estimate for the current year, FY07 as well as for FY08 stands reduced by 6.9% and 5.4%, respectively.

Table 2: Revised estimates

	Earlier		Revised		% change	
	FY07E	FY08E	FY07E	FY08E	FY07E	FY08E
Revenue (INR mn)	61,638	76,654	60,833	76,654	(1.3)	0.0
Net profit (INR mn)	10,943	13,394	10,189	12,650	(6.9)	(5.6)
EPS (INR)	33.6	40.8	31.3	38.6	(6.9)	(5.4)

Source: Edelweiss research

Valuations

We have revised our FY07 and FY08 estimates to take into account higher-than-expected ESOP and RSU charges that the company will be taking into its financials. This has led to a downward revision in the EPS by 6.9% to INR 31.3 and 5.4% to INR 38.6 for FY07E and FY08E, respectively. At CMP of INR 639, the stock trades at a P/E of 20.4x and 16.6x and EV/EBITDA of 14.9x and 11.1x for our FY07E and FY08E revised earnings, respectively.

Financials snapshot (INR mn)

Year to June	Q2FY07	Q1FY07	*Growth %*	Q2FY06	*Growth %*	FY06	FY07E	FY08E
Total revenues	14,651	13,795	*6.2*	10,542	*39.0*	44,007	60,833	76,654
Direct cost	9,107	8,708	*4.6*	6,564	*38.7*	27,579	38,108	47,986
Gross profit	5,544	5,087	*9.0*	3,978	*39.4*	16,428	22,725	28,669
SG&A expenses	2,303	2,098	*9.8*	1,601	*43.8*	6,580	9,341	11,192
EBITDA	3,241	2,989	*8.4*	2,377	*36.3*	9,848	13,384	17,477
Depreciation	623	557	*11.8*	493	*26.4*	2,032	2,458	3,253
EBIT	2,618	2,432	*7.6*	1,884	*39.0*	7,816	10,926	14,224
Other income	481	290	*65.9*	143	*236.4*	578	1,301	1,380
Profit before tax	3,099	2,722	*13.9*	2,027	*52.9*	8,394	12,227	15,604
Tax provision	206	219	*(5.9)*	203	*1.5*	626	963	1,888
Profit after tax	2,893	2,503	*15.6*	1,824	*58.6*	7,768	11,264	13,716
Share in equity investment	(7.0)	4.0	*(275.0)*	(7.0)	-	(6.0)	4.0	20.0
Minority interest	(23.0)	(5.0)	*360.0*	(6.0)	*283.3*	(16.0)	(41.0)	(30.0)
Adjusted net profit	2,863	2,502	*14.4*	1,811	*58.1*	7,746	11,227	13,706
Stock based charges	266.0	202.0		160.0		160.0	1,038.5	1,056.0
Extraordinary item	-	-		-		-	-	-
Reported net profit	2,597	2,300	*12.9*	1,651	*57.3*	7,586	10,189	12,650
Adjusted EPS	8.8	7.7	*14.3*	5.6	*56.7*	24.0	31.3	38.6
as % of net revenues								
Gross profit	37.8	36.9		37.7		37.3	37.4	37.4
SG&A expenses	15.7	15.2		15.2		15.0	15.4	14.6
EBITDA	22.1	21.7		22.5		22.4	22.0	22.8
EBIT	17.9	17.6		17.9		17.8	18.0	18.6
Net profit	17.7	16.7		15.7		17.2	16.7	16.5
Tax rate	6.6	8.0		10.0		7.5	7.9	12.1

Company description

HCL Technologies is India's fifth largest IT services company. It provides software-led IT solutions, remote infrastructure management and BPO services focusing mainly on transformational outsourcing. The company leverages off its extensive offshore infrastructure and global network of offices in 16 countries to deliver solutions across select verticals including financial services, retail & consumer, life sciences aerospace, automotive, semiconductors, telecom and MPE (media publishing & entertainment). HCL Tech's employee force stands at 38,317 and its revenues for the past twelve months (TTM) stood at INR 52.2 bn (USD 1.2 bn).

Investment theme

Industry revenues are forecasted to grow at 25-30% over FY10 and as a scale player HCL Tech is expected to gradually increase its share of the total pie. HCL Tech has been at the forefront in pursuing large deals. It has won some of the largest deals announced in the Indian IT space such as DSG International, Autodesk, Teradyne and AXA, which provide long term revenue visibility. HCL's well-established large sized practices—BPO and infrastructure management—have substantial untapped offshoring potential. HCL's leading position in both these business provides it a strong annuity base and improves consistency levels. We expect HCL's revenues and net profits to grow at a CAGR of 32.0% and 29.1%, respectively over FY06-08E.

Risks to investment theme

Key risks to our investment theme include: (a) sustained slowdown in the US; (b) maintaining the margins while pursuing large deals; (c) significant increase in salary hikes and attrition rate creating cost pressures; and (d) any substantial appreciation of the rupee against US dollar, Euro, and GBP.

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Yogesh Radke	-	2286 4328	Alternative & Quantitative	Ravi Pilani	-	4009 4533
				Dipesh Shah	-	2286 4434

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RATING INTERPRETATION

Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period

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