

Company Flash

13 August 2007 | 8 pages

HCL Technologies (HCLT.BO)

Buy: 4QFY07 In-Line Operationally

- Operationally in-line; 4th quarter of 9%+ qoq** — HCL Tech's Q4FY07 results were in-line with expectations – higher than expected revenue growth (+9.2% qoq in US\$-terms) but lower than expected margins (~170bp qoq) resulted in EBITDA of \$85m (as against expectation of \$86m). Margins were lower on account of INR – net income was significantly higher due to forex gains.
- Momentum in infrastructure services continues** — Infrastructure services reported another strong quarter with revenues growing 18% qoq. However, margins in infrastructure services declined around 100bps qoq – due to INR.
- IT Services reports another decent quarter** — IT Services reported sequential growth of 7.6% qoq. Volume growth was 6.5% qoq while offshore realizations improved ~180bp qoq.
- BPO - headcount declines sharply** — BPO reported revenues of \$54m – growth of 8.5% sequentially. Low hiring coupled with attrition in the quarter resulted in headcount declining by ~1200. In our view, this could be due to management focus on improving utilization to counter the challenge of sharp appreciation in INR - gross margins in BPO improved ~70bps qoq.
- Guidance of 30% growth + margin expansion** — HCL Tech management guided to ~30% growth for FY08 and indicated that margin expansion should continue. HCL Tech now has ~Rs.33 per share of cash and dividend yield of 2.5%. The stock trades at 17x FY08E – maintain our Buy/Medium Risk rating on the stock.

Buy/Medium Risk	1M
Price (13 Aug 07)	Rs317.35
Target price	Rs400.00
Expected share price return	26.0%
Expected dividend yield	3.2%
Expected total return	29.2%
Market Cap	Rs210,630M US\$5,204M

Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
30 Jun	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2005A	6,104	9.56	9.1	33.2	2.7	18.1	1.6
2006A	7,091	10.46	9.4	30.3	5.0	18.1	2.5
2007E	10,874	15.91	52.2	19.9	4.2	24.4	2.5
2008E	12,593	18.34	15.2	17.3	3.7	24.3	2.5
2009E	15,006	21.85	19.2	14.5	3.2	25.1	2.5

Source: Powered by dataCentral

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Other key highlights

- Software services revenues increased 37% yoy (\$ terms) in FY07 while margins declined ~40bp yoy to ~23%.
- Infrastructure services reported growth of 75% yoy (\$ terms) in FY07 while margins expanded ~200bp yoy to 17%.
- BPO revenues increased 41% yoy with EBITDA margins remaining stable at ~24.5%.
- According to the company, EBIT growth was 15% qoq (adjusting for forex).
- HCL Tech had \$1.16b of outstanding hedges at the end of the quarter for the next six quarters. In Q4FY07, HCL Tech reported forex gains of \$61m out of which \$10m pertain to Q4FY07.
- 7 large deals announced in the quarter including Fonterra of New Zealand.
- ESOP cost for the next year is expected to be ~\$24m.
- \$9m of transition-related revenues and \$3m of profits not recognized in FY07 as per US GAAP.

Figure 1. Key Financials

Rs mn	4Q06	3Q07	4Q07	QoQ	YoY
Revenue (US\$ m)	272	362	396	9.2%	45.3%
Revenue	12,538	15,771	16,120	2.2%	28.6%
Cost of revenue	7,946	9,738	10,039	3.1%	26.3%
Gross profit	4,592	6,033	6,081	0.8%	32.4%
Gross margin	36.6%	38.3%	37.7%	-53bp	110bp
Operating expenses	1,777	2,366	2,607	10.2%	46.7%
EBITDA	2,815	3,667	3,474	-5.3%	23.4%
EBITDA margin	22.5%	23.3%	21.6%	-170bp	-90bp
Depreciation and amortization	562	659	693	5.2%	23.3%
EBIT	2,253	3,008	2,781	-7.5%	23.4%
EBIT margin	18.0%	19.1%	17.3%	-182bp	-72bp
Other income	56	615	2,873	367.2%	5030.4%
Profit before tax	2,309	3,623	5,654	56.1%	144.9%
Income tax expense	-23	283	777	n.a.	-3478.3%
Income from operations	2,332	3,340	4,877	46.0%	109.1%
Affiliates/Minority	-1	-23	-10	n.a.	n.a.
Net income - before ESOP charges	2,331	3,317	4,867	46.7%	108.8%
Net ESOP charges	-207	-304	-200	n.a.	n.a.
Net profit	2,124	3,013	4,667	54.9%	119.7%
EPS - basic	3.63	5.10	7.33	43.8%	102.2%
EPS - diluted	3.41	4.83	7.12	47.4%	109.0%

Source: Company Reports

Figure 2. Segment wise Financials

	1Q07	2Q07	3Q07	4Q07
HCL Tech - consolidated				
Revenue (Rs mn)	13,794	14,651	15,771	16,120
Change - qoq	10.0%	6.2%	7.6%	2.2%
EBITDA margin	21.7%	22.1%	23.3%	21.6%
Change - qoq	-78bp	45bp	113bp	-170bp
IT services				
Revenue (Rs mn)	10,206	10,739	11,421	11,505
Change - qoq	9.7%	5.2%	6.4%	0.7%
EBITDA margin	22.3%	22.9%	23.7%	21.8%
Change - qoq	-98bp	62bp	85bp	-194bp
Infrastructure services				
Revenue (Rs mn)	1825	2053	2186	2417
Change - qoq	16.6%	12.5%	6.5%	10.6%
EBITDA margin	17.6%	17.5%	17.6%	16.7%
Change - qoq	14bp	-10bp	13bp	-94bp
BPO services				
Revenue (Rs mn)	1,763	1,859	2,164	2,198
Change - qoq	5.4%	5.4%	16.4%	1.6%
EBITDA margin	22.4%	22.9%	26.5%	25.8%
Change - qoq	-38bp	51bp	361bp	-77bp

Source: Company Reports

Figure 3. Manpower and Execution metrics

	1Q07	2Q07	3Q07	4Q07
Total manpower				
Total manpower	36,402	38,317	40,149	42,017
Net addition	3,776	1,915	1,832	1,868
A. Software services				
Total manpower				
Total manpower	21,943	22,523	23,796	26,326
Delivery	19,657	20,004	21,013	23,160
Support	2,286	2,519	2,783	3,166
B. BPO services				
Total manpower				
Total manpower	11,062	12,181	12,354	11,252
Delivery	10,340	11,343	11,407	10,212
Support	722	838	947	1,040
C. Infrastructure services				
Total manpower				
Total manpower	3,397	3,613	3,999	4,439
Delivery	2,867	3,071	3,418	3,794
Support	530	542	581	645
Efforts - IT services				
Billed	42,213	46,264	48,053	51,162
- offshore	30,593	33,986	34,965	37,129
- onsite	11,620	12,278	13,088	14,033
Unbilled	10,055	12,177	12,361	11,943
Trainees	5,853	3,414	3,351	3,774
Utilization - IT services				
Offshore	67.9%	69.4%	69.8%	71.1%
offshore ex trainees	77.7%	74.6%	74.8%	76.7%
Onsite	92.2%	95.2%	95.6%	95.6%
Revenue Mix - IT services				
- offshore	48.2%	49.0%	47.7%	47.9%
- onsite	51.8%	51.0%	52.3%	52.1%
Attrition				
IT services - LTM	16.5%	17.8%	17.5%	17.3%
BPO - quarterly	18.5%	19.9%	19.5%	17.5%
Infrastructure services - LTM	13.1%	16.8%	16.4%	17.3%

Source: Company Reports

Figure 4. Revenue Mix

	1Q07	2Q07	3Q07	4Q07
Service Offering				
R&D and Engg services	24.0%	24.2%	23.3%	23.9%
Enterprise Application services	13.7%	12.7%	13.2%	12.0%
Application services	36.2%	36.3%	35.8%	35.5%
Infrastructure services	13.3%	14.0%	13.8%	15.0%
BPO services	12.8%	12.7%	13.7%	13.6%
Geography				
US	59.6%	57.3%	54.3%	56.1%
Europe	28.6%	29.2%	30.2%	29.7%
AsiaPac	11.8%	13.5%	15.5%	14.2%
Verticals				
BFSI	22.8%	27.2%	27.5%	28.7%
Manufacturing, Hi-Tech	31.3%	29.7%	28.9%	28.7%
Telecom	16.9%	16.2%	17.2%	17.2%
Retail	12.0%	10.6%	9.4%	9.2%
Media and Entertainment	5.9%	5.9%	5.6%	5.6%
Life Sciences	3.5%	4.0%	4.5%	4.9%
Others	7.6%	6.4%	6.8%	5.7%

Source: Company Reports

HCL Technologies

Company description

HCL Tech is the fifth-largest Indian IT services company. Founded in 1991, HCL Tech 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 is the third-largest offshore services provider and boasts strong ties with British Telecom and SBC. The company leverages off its extensive offshore infrastructure and its global network of 26 offices in 15 countries to deliver solutions across verticals including Banking, Insurance, Retail & Consumer, Aerospace, Automotive, Semiconductors, Telecom and Life Sciences. HCL Tech has more than 230 clients across verticals, and a workforce of 40,000.

Investment thesis

We rate HCL Tech as Buy/Medium (1M) Risk. Based on our analysis, offshore IT services demand will remain strong, with industry revenues forecast to grow 25-30% pa over the next four years. HCL Tech has been at the forefront of pursuing large deals. It has won at least four multi-year US\$50m-plus deals in the past fiscal year. Significant presence across IT services, BPO services and IMS has helped HCL Tech to qualify for multi-year outsourcing deals. Infrastructure-management services, R&D and BPO service offerings should enable it to post strong revenue growth. We forecast 28% revenue CAGR and 28% EPS CAGR for FY06-09. The stock has underperformed the Sensex for the past two quarters.

Valuation

Our 12-month target price is Rs400 based on 18x FY09E EPS. We value HCL Tech relative to Satyam, which is similar to HCL Tech in terms of revenue. We expect a 28% CAGR in earnings for the next three years, and believe the stock should trade toward the higher end of its historical three-year trading range of 14-23x 12-month forward earnings. HCL Tech has traded on a par with Satyam in the past two years. Our P/E target is based on a ~5% discount to our target multiple of 19x for Satyam primarily because of lower growth and return ratios

than Satyam. We believe P/E remains the most appropriate valuation measure given HCL Tech's past profitability and future earnings visibility.

Risks

We rate HCL Tech as Medium Risk based on our quantitative risk-rating system, which tracks 260-day historical share price volatility. The key downside risks that could impede the stock from reaching our target price include: (1) significant QoQ volatility in growth rates; (2) any significant appreciation of the rupee against the US dollar/euro/pound; (3) a sharp slowdown in the US economy; (4) a slowdown in the banking, financial services and insurance (BFSI) sector; (5) H1B visa quotas; (6) acquisition-related risks; and (7) the strategy of pursuing large deals could have negative margin implications.

Appendix A-1

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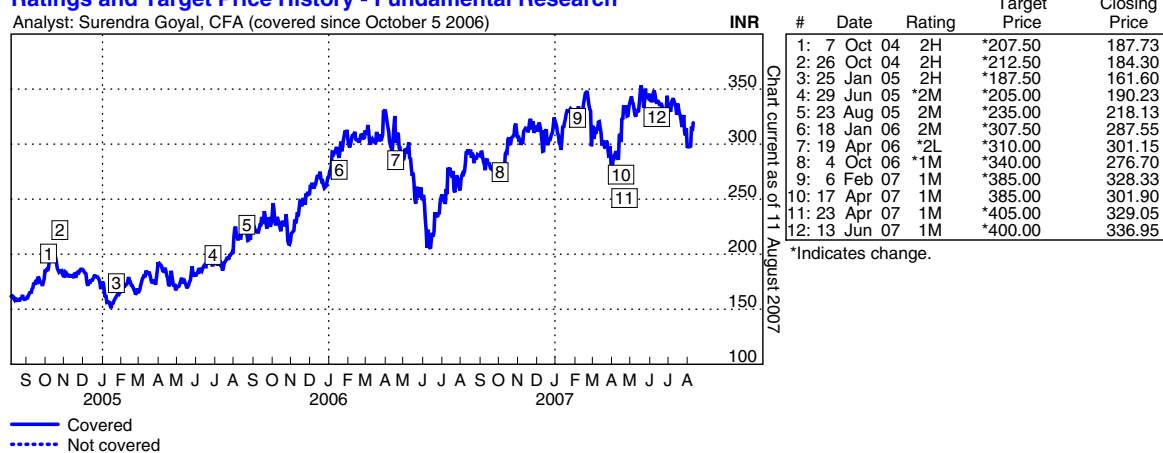
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Analyst: Surendra Goyal, CFA (covered since October 5 2006)



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