Company Flash

16 October 2007 | 8 pages

HCL Technologies (HCLT.BO)

Buy: 1QFY08 Revenues In-Line; BPO Business Sluggish

- **Revenues in-line; margins ahead of expectations** — HCL Tech (HCLT) reported 1QFY08 revenues of $429m (our exp: $428m) – growth of 8.4% qoq. EBITDA margins declined 30bp to 21.3% (our exp: 20.5%) despite wage hikes.
- **IT Services & Infrastructure services did well** — IT Services reported a 10% growth qoq to $311m. Volumes increased 9%; pricing was up ~2% qoq. Infrastructure services had another decent quarter – revenue growth of 10% qoq to $65m and flat EBITDA margins of 16.8%.
- **BPO business sluggish** — BPO revenues grew 3% qoq to $55m. Headcount was flat qoq after a sharp decline of ~1200 employees in Q4FY07. The BPO business lost a customer (~5% of BPO and 0.6% of revenues in Q1) due to M&A and contract being taken in-house subsequently.
- **Good hiring in IT/Infrastructure services** — HCL Tech hired 2,831 employees in IT Services (~11% of headcount at end of Q4FY07) and ~780 employees (~17% of headcount at end of Q4FY07).
- **Accounting policy lowers reported net profit** — Effective July 1, 2007, HCLT has moved to cash flow hedge accounting. This has resulted in gains of $55.7m being accounted in balance sheet (instead of P&L). This also resulted in a gain of $1.5m on the revenue line in this quarter.
- **Valuations reasonable; macro overhang** — Valuations remain reasonable at ~14x FY09E earnings; dividend yield of 2.6%. Investor concerns on (1) INR appreciation and (2) Possibility of demand slowdown remains an overhang.

Buy/Medium Risk	**1M**
Price (16 Oct 07)	Rs302.50
Target price	Rs400.00
Expected share price return	32.2%
Expected dividend yield	3.3%
Expected total return	**35.5%**
Market Cap	Rs200,792M
	US$5,122M

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

Statistical Abstract

Year to 30 Jun	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	6,104	9.56	9.1	31.6	2.5	18.1	1.7
2006A	7,091	10.46	9.4	28.9	4.8	18.1	2.6
2007E	10,874	15.91	52.2	19.0	4.0	24.4	2.6
2008E	12,593	18.34	15.2	16.5	3.6	24.3	2.6
2009E	15,006	21.85	19.2	13.8	3.1	25.1	2.6

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.

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Other Key Highlights

- HCLT signed a $250m+ integrated services deal in this quarter making it the third US$200m+ deal in the last two years.
- HCL Tech also signed a multiservice multimillion dollar deal with Hercules.
- HCL Tech reported 7.8% yoy growth in realizations/employee. New contracts are coming in at 5-15% better rates while existing contracts are being renegotiated at 3-5% better rates. Rates are improving primarily due to change in mix of services.
- Attrition came down in both IT Services & BPO for the fourth quarter in a row – attrition for IT services was 16.5% (LTM basis) and BPO was 14.2% (quarterly basis).
- 12% of Q1 revenues came in from large deals signed over last few years.
- EBIT margins remained flat at 17.3% qoq – negative impact of wage hikes and lower utilization was balanced by better realizations, higher offshore and SG&A leverage.
- Unrealized gains on treasury investments were $20.8m at the end of Q1 against $19.5m last quarter.
- HCLT had hedge position of $1.86b at the end of Q1 (covers next 9 quarters).
- HCLT raised India salaries by ~15% and onsite salaries by ~3-4% in the quarter.
- Capex in the quarter was $28m and the company expects $150m capex for FY08.

Figure 1. Key financials

Rs mn	1Q07	4Q07	1Q08	QoQ	YoY
Revenue (US$ m)	**300**	**396**	**429**	**8.4%**	**42.8%**
Revenue	**13,795**	**16,120**	**17,092**	**6.0%**	**23.9%**
Cost of revenue	8,708	10,039	10,763	7.2%	23.6%
Gross profit	5,087	6,081	6,329	4.1%	24.4%
Gross margin	36.9%	37.7%	37.0%	-69bp	15bp
Operating expenses	2,098	2,607	2,690	3.2%	28.2%
EBITDA	**2,989**	**3,474**	**3,639**	**4.7%**	**21.7%**
EBITDA margin	***21.7%***	***21.6%***	***21.3%***	***-26bp***	***-38bp***
Depreciation and amortization	557	693	686	-1.0%	23.2%
EBIT	**2,432**	**2,781**	**2,953**	**6.2%**	**21.4%**
EBIT margin	***17.6%***	***17.3%***	***17.3%***	***3bp***	***-35bp***
Other income	290	2,873	504	-82.5%	73.8%
Profit before tax	2,722	5,654	3,457	-38.9%	27.0%
Income tax expense	219	777	346	n.a.	58.0%
Income from operations	2,503	4,877	3,111	-36.2%	24.3%
Affiliates/Minority	-1	-10	-28	n.a.	n.a.
Net income - recurring	2,502	4,867	3,083	-36.7%	23.2%
EO income/(loss)	-202	-200	-250	n.a.	n.a.
Net profit	2,300	4,667	2,833	-39.3%	23.2%
EPS - basic	3.86	7.33	4.65	-36.7%	20.2%
EPS - diluted	3.70	7.12	4.53	-36.4%	22.4%

Source: Company Reports

Figure 2. Segment wise financials

	1Q07	2Q07	3Q07	4Q07	1Q08
HCL Tech - consolidated					
Revenue (Rs mn)	13,794	14,651	15,771	16,120	17,094
Change - qoq	10.0%	6.2%	7.6%	2.2%	6.0%
EBITDA margin	21.7%	22.1%	23.3%	21.6%	21.3%
Change - qoq	-78bp	45bp	113bp	-170bp	-26bp
IT services					
Revenue (Rs mn)	10,206	10,739	11,421	11,505	12,316
Change - qoq	9.7%	5.2%	6.4%	0.7%	7.0%
EBITDA margin	22.3%	22.9%	23.7%	21.8%	21.4%
Change - qoq	-98bp	62bp	85bp	-194bp	-39bp
Infrastructure services					
Revenue (Rs mn)	1,825	2,053	2,186	2,417	2,580
Change - qoq	16.6%	12.5%	6.5%	10.6%	6.7%
EBITDA margin	17.6%	17.5%	17.6%	16.7%	16.8%
Change - qoq	14bp	-10bp	13bp	-94bp	15bp
BPO services					
Revenue (Rs mn)	1,763	1,859	2,164	2,198	2,198
Change - qoq	5.4%	5.4%	16.4%	1.6%	0.0%
EBITDA margin	22.4%	22.9%	26.5%	25.8%	26.1%
Change - qoq	-38bp	51bp	361bp	-77bp	32bp

Source: Company Reports

Figure 3. Manpower and execution metrics

	1Q07	2Q07	3Q07	4Q07	1Q08
Total manpower	36,402	38,317	40,149	42,017	45,642
Net addition	3,776	1,915	1,832	1,868	3,625
A. Software services					
Total manpower	21,943	22,523	23,796	26,326	29,157
Delivery	19,657	20,004	21,013	23,160	25,667
Support	2,286	2,519	2,783	3,166	3,490
B. BPO services					
Total manpower	11,062	12,181	12,354	11,252	11,262
Delivery	10,340	11,343	11,407	10,212	10,220
Support	722	838	947	1,040	1,042
C. Infrastructure services					
Total manpower	3,397	3,613	3,999	4,439	5,223
Delivery	2,867	3,071	3,418	3,794	4,543
Support	530	542	581	645	680
Efforts - IT services					
Billed	42,213	46,264	48,053	51,162	55,754
- offshore	30,593	33,986	34,965	37,129	41,187
- onsite	11,620	12,278	13,088	14,033	14,567
Unbilled	10,055	12,177	12,361	11,943	12,813
Trainees	5,853	3,414	3,351	3,774	6,186
Utilization - IT services					
Offshore	67.9%	69.4%	69.8%	71.1%	69.2%
Offshore ex trainees	77.7%	74.6%	74.8%	76.7%	77.2%
Onsite	92.2%	95.2%	95.6%	95.6%	95.8%
Revenue Mix - IT services					
- offshore	48.2%	49.0%	47.7%	47.9%	49.4%
- onsite	51.8%	51.0%	52.3%	52.1%	50.6%
Attrition					
IT services - LTM	16.5%	17.8%	17.5%	17.3%	16.5%
BPO - quarterly	18.5%	19.9%	19.5%	17.5%	14.2%
Infrastructure services - LTM	13.1%	16.8%	16.4%	17.3%	15.9%

Source: Company Reports

Figure 4. Revenue mix

	1Q07	2Q07	3Q07	4Q07	1Q08
Service Offering					
R&D and Engg services	24.0%	24.2%	23.3%	23.9%	24.8%
Enterprise Application services	13.7%	12.7%	13.2%	12.0%	11.8%
Application services	36.2%	36.3%	35.8%	35.5%	35.5%
Infrastructure services	13.3%	14.0%	13.8%	15.0%	15.1%
BPO services	12.8%	12.7%	13.7%	13.6%	12.8%
Geography					
US	59.6%	57.3%	54.3%	56.1%	54.2%
Europe	28.6%	29.2%	30.2%	29.7%	30.8%
AsiaPac	11.8%	13.5%	15.5%	14.2%	15.0%
Verticals					
BFSI	22.8%	27.2%	27.5%	28.7%	28.7%
Manufacturing, Hi-Tech	31.3%	29.7%	28.9%	28.7%	30.0%
Telecom	16.9%	16.2%	17.2%	17.2%	16.3%
Retail	12.0%	10.6%	9.4%	9.2%	8.7%
Media and Entertainment	5.9%	5.9%	5.6%	5.6%	5.5%
Life Sciences	3.5%	4.0%	4.5%	4.9%	5.2%
Others	7.6%	6.4%	6.8%	5.7%	5.6%

Source: Company Reports

Figure 5. Client metrics

	1Q07	2Q07	3Q07	4Q07	1Q08
Client relationships					
No. of 1 mn $ clients	143	145	147	156	166
No. of 5 mn $ clients	41	46	48	52	55
No. of 10 mn $ clients	18	22	25	26	27
No. of 20 mn $ clients	8	8	10	13	13
Client concentration			5	7	8
Top 5 Clients	28.7%	29.7%	29.2%	28.4%	27.8%
Top 10 Clients	38.2%	39.0%	38.5%	38.2%	38.0%
Top 20 Clients	49.9%	51.5%	50.9%	51.1%	50.7%

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 strategy

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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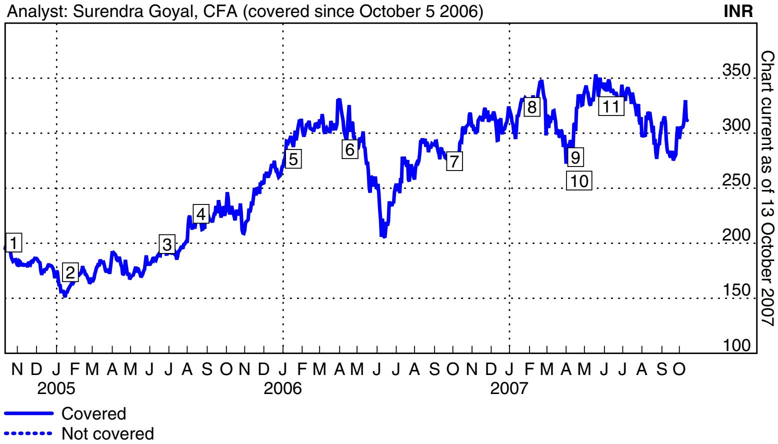
HCL Technologies (HCLT.BO)

Ratings and Target Price History - Fundamental Research

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



#	Date	Rating	Target Price	Closing Price
1:	26 Oct 04	2H	*212.50	184.30
2:	25 Jan 05	2H	*187.50	161.60
3:	29 Jun 05	*2M	*205.00	190.23
4:	23 Aug 05	2M	*235.00	218.13
5:	18 Jan 06	2M	*307.50	287.55
6:	19 Apr 06	*2L	*310.00	301.15
7:	4 Oct 06	*1M	*340.00	276.70
8:	6 Feb 07	1M	*385.00	328.33
9:	17 Apr 07	1M	385.00	301.90
10:	23 Apr 07	1M	*405.00	329.05
11:	13 Jun 07	1M	*400.00	336.95

*Indicates change.

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