

Company Flash

17 April 2007 | 9 pages

HCL Technologies (HCLT.BO)

Buy: Another Strong Quarter

- Q3FY07 surprises positively** — Q3FY07 surprised positively yet again with a revenue 9.6% qoq growth (\$ term). Margins increased yet again to 23.3%. Over the last 4 quarters, HCL Tech's revenues (\$ term) and EBITDA (excluding non cash charges) have increased at a CQGR of 9.6% and 10.1%, respectively.
- All segments performing well** — Q3 was another quarter of all round growth – IT Services witnessed a growth of 8.2% qoq, BPO grew 18.4% qoq while infrastructure services revenues increased 8.1% qoq (all \$ terms).
- EBITDA margins expand again** — EBITDA margins expanded by ~110 bps qoq again (after a 40bp improvement in 2Q). All segments reported improved profitability – IT services margins improved 85bp qoq while BPO margins improved 360bp qoq. Margin expansion was due to improved realizations, lower SG&A, better utilizations partly offset by currency and wage hike in BPO.
- Net profits growth of 16% qoq** — EBITDA growth was 13% qoq (excluding non cash charges). Higher other income resulted in net profits growing by 16% qoq.
- Expect consensus upgrades; maintain Buy (1M)** — With a 10% surprise on our numbers and a significant surprise on the street numbers as well – consensus upgrades are likely. HCL Tech's large deal strategy is paying off – qoq volatility has come down over the last few quarters. The stock trades at 16.6x FY08E – we reiterate our Buy/Medium Risk rating.

Buy/Medium Risk	1M
Price (17 Apr 07)	Rs301.90
Target price	Rs385.00
Expected share price return	27.5%
Expected dividend yield	2.6%
Expected total return	30.2%
Market Cap	Rs200,366M US\$4,796M

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	31.6	2.5	18.1	1.7
2006A	7,091	10.46	9.4	28.9	4.8	18.1	2.6
2007E	10,496	15.40	47.2	19.6	4.3	24.3	2.6
2008E	12,460	18.23	18.4	16.6	3.7	25.3	29.1
2009E	14,995	21.94	20.3	13.8	3.2	26.3	2.6

Source: Powered by dataCentral

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

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Other key points

- **EBITDA growth strong** - EBITDA growth was 13% qoq (excluding non cash charges). Higher other income resulted in net profits growing by 16% qoq. At a company level, the positive drivers for margins were SG&A (+90bp), realizations (+75bp), utilization (+20bp) while the negative drivers were currency (-54bp) and wage increase in BPO (-15bp) – netting off to ~125bp increase in margins.
- **Hiring remains strong** – HCL Tech hired ~1800 employees in the quarter – over the last 4 quarters, HCL Tech has added 34% to its employee base. HCL Tech has also made campus offers to 5000 candidates.
- **Volume growth in IT services muted** – Volume growth in IT services (3.9% qoq) was muted.
- **Average realizations in software up 4%** – Implied pricing in software services increased by 4% qoq. Management indicated that 1.7% increase was on account of higher realization, 1.7% was due to mix change (higher onsite) and remaining was a non-effort based increase.
- **Margins improved in IT Services at ~80bp** – The margin expansion was on account of higher utilization (+20bp), higher realizations (+84bp) and reduced SG&A (+50bp) being offset by negative impact of currency (-64bp).
- **Europe/Asia pacific report strong growth** – US revenues grew 6% in \$ terms while Europe and Asia Pacific delivered very strong growth of 12.5% and 26% respectively. ANZ (Australia/New Zealand) revenue growth was 16.3% qoq.
- **Microvertical strategy paying off** – Aerospace, which is one of the focus microverticals, has witnessed a growth of 95% yoy. Lifescience also witnessed a growth of 90% yoy.
- **HCL Tech announces 6 deal wins** – HCL Tech announced 6 large deal wins – one of them is >\$50m in size and another 5 in the range \$25-50m. 4 of them are in Hi-tech manufacturing and 2 in BFSI.
- **Attrition** – Attrition in IT Services declined marginally from 17.8% in Q2 to 17.5% in Q3 (on a TTM basis). BPO attrition (of employees greater than 6 months experience) increased to 8.8% (from 5.9% in the previous quarter).
- **DSO's down again** – DSO's now stand at 68 as against 70 days at the end of the prior quarter.
- **Unrealized treasury gains** – Unrealized treasury gains at the end of the quarter stand at \$18.1m (as against \$15.3m at the end of previous quarter).
- **ESOP charge** – ESOP charge to be \$22.8m this year and \$22m for FY08.
- **Wage hikes** – HCL Tech management expects wage hikes of 12-15% for offshore employees while onsite wage hikes are expected to be 3-5%. HCL Tech indicated that campus wages have been increased 15% yoy (from Rs. 220,000 per annum last year).
- **Forex cover increased** – HCL Tech has increased the forex cover to ~\$900m as compared to \$515m at the end of the previous quarter.

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Figure 1. Key Financials, Rs mn

	3Q06	2Q07	3Q07	QoQ	YoY
Revenue (US\$ m)	252	331	362	9.5%	44.1%
Revenue	11,220	14,651	15,771	7.6%	40.6%
Cost of revenue	6,978	9,107	9,738	6.9%	39.6%
Gross profit	4,242	5,544	6,033	8.8%	42.2%
<i>Gross margin</i>	<i>37.8%</i>	<i>37.8%</i>	<i>38.3%</i>	<i>41bp</i>	<i>45bp</i>
Operating expenses	1,744	2,303	2,366	2.7%	35.7%
EBITDA	2,498	3,241	3,667	13.1%	46.8%
<i>EBITDA margin</i>	<i>22.3%</i>	<i>22.1%</i>	<i>23.3%</i>	<i>113bp</i>	<i>99bp</i>
Depreciation and amortization	530	623	659	5.8%	24.3%
EBIT	1,968	2,618	3,008	14.9%	52.8%
<i>EBIT margin</i>	<i>17.5%</i>	<i>17.9%</i>	<i>19.1%</i>	<i>120bp</i>	<i>153bp</i>
Other income	255	481	615	27.9%	141.2%
Profit before tax	2,223	3,099	3,623	16.9%	63.0%
Income tax expense	277	206	283	n.a.	2.2%
Income from operations	1,946	2,893	3,340	15.5%	71.6%
Affiliates/Minority	-17	-30	-23	n.a.	n.a.
Net income – before option charges	1,929	2,863	3,317	15.9%	72.0%
Non-cash charges	-183	-266	-304	n.a.	n.a.
Net profit	1,747	2,597	3,013	16.0%	72.5%
EPS - basic	3.01	4.41	5.10	15.5%	69.6%
EPS - diluted	2.88	4.19	4.83	15.3%	67.9%

Source: Company Reports

Figure 2. Segment wise results

	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07
HCL Tech - consolidated							
Revenue (Rs mn)	9,710	10,542	11,220	12,538	13,794	14,651	15,771
<i>Change - qoq</i>		<i>8.6%</i>	<i>6.4%</i>	<i>11.7%</i>	<i>10.0%</i>	<i>6.2%</i>	<i>7.6%</i>
EBITDA margin	22.2%	22.5%	22.3%	22.5%	21.7%	22.1%	23.3%
<i>Change - qoq</i>		<i>32bp</i>	<i>-28bp</i>	<i>19bp</i>	<i>-78bp</i>	<i>45bp</i>	<i>113bp</i>
IT services							
Revenue (Rs mn)	7,434	8,001	8,348	9,301	10,206	10,739	11,421
<i>Change - qoq</i>		<i>7.6%</i>	<i>4.3%</i>	<i>11.4%</i>	<i>9.7%</i>	<i>5.2%</i>	<i>6.4%</i>
EBITDA margin	22.8%	22.9%	23.5%	23.2%	22.3%	22.9%	23.7%
<i>Change - qoq</i>		<i>14bp</i>	<i>58bp</i>	<i>-24bp</i>	<i>-98bp</i>	<i>62bp</i>	<i>85bp</i>
Infrastructure services							
Revenue (Rs mn)	969	1202	1307	1565	1825	2053	2186
<i>Change - qoq</i>		<i>24.0%</i>	<i>8.7%</i>	<i>19.7%</i>	<i>16.6%</i>	<i>12.5%</i>	<i>6.5%</i>
EBITDA margin	12.6%	15.1%	15.4%	17.4%	17.6%	17.5%	17.6%
<i>Change - qoq</i>		<i>247bp</i>	<i>32bp</i>	<i>207bp</i>	<i>14bp</i>	<i>-10bp</i>	<i>13bp</i>
BPO services							
Revenue (Rs mn)	1,307	1,339	1,565	1,672	1,763	1,859	2,164
<i>Change - qoq</i>		<i>2.4%</i>	<i>16.9%</i>	<i>6.8%</i>	<i>5.4%</i>	<i>5.4%</i>	<i>16.4%</i>
EBITDA margin	26.3%	27.2%	21.5%	22.8%	22.4%	22.9%	26.5%
<i>Change - qoq</i>		<i>86bp</i>	<i>-565bp</i>	<i>125bp</i>	<i>-38bp</i>	<i>51bp</i>	<i>361bp</i>

Source: Company Reports

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Figure 3. Key HR metrics

	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07
Total manpower	26,285	28,182	29,948	32,626	36,402	38,317	40,149
Net addition	2,198	1,897	1,766	2,678	3,776	1,915	1,832
A. Software services							
Total manpower	17,708	17,793	18,623	20,332	21,943	22,523	23,796
Delivery	16,116	16,020	16,616	18,156	19,657	20,004	21,013
Support	1,592	1,773	2,007	2,176	2,286	2,519	2,783
B. BPO services							
Total manpower	6,772	8,334	8,903	9,343	11,062	12,181	12,354
Delivery	6,228	7,533	8,149	8,596	10,340	11,343	11,407
Support	544	801	754	747	722	838	947
C. Infrastructure services							
Total manpower	1,805	2,055	2,422	2,951	3,397	3,613	3,999
Delivery	1,403	1,670	2,018	2,466	2,867	3,071	3,418
Support	402	385	404	485	530	542	581

Source: Company Reports

Figure 4. Key Execution metrics

	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07
Efforts							
Billed	34,875	37,521	39,304	40,953	42,213	46,264	48,053
- offshore	26,200	28,174	29,150	30,093	30,593	33,986	34,965
- onsite	8,675	9,347	10,154	10,860	11,620	12,278	13,088
Unbilled	9,728	10,154	9,463	9,100	10,055	12,177	12,361
Trainees	4,350	2,259	2,253	3,402	5,853	3,414	3,351
Utilization							
Offshore	67.0%	70.4%	72.6%	71.8%	67.9%	69.4%	69.8%
offshore ex trainees	75.4%	76.4%	76.9%	78.1%	77.7%	74.6%	74.8%
Onsite	88.1%	94.1%	93.5%	94.2%	92.2%	95.2%	95.6%
Revenue Mix							
- offshore	49.5%	50.6%	48.2%	48.6%	48.2%	49.0%	47.7%
- onsite	50.5%	49.4%	51.8%	51.4%	51.8%	51.0%	52.3%
Attrition							
IT services - LTM	17.6%	19.5%	17.8%	16.9%	16.5%	17.8%	17.5%
BPO - quarterly	n.a.	14.2%	15.8%	16.7%	18.5%	19.9%	19.5%
Infrastructure services - LTM	26.0%	23.6%	20.0%	13.7%	13.1%	16.8%	16.4%

Source: Company Reports

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Figure 5. Revenue Mix

	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07
Service Offering							
R&D and Engg services	24.1%	23.4%	23.6%	23.9%	24.0%	24.2%	23.3%
Enterprise Application services	18.2%	18.2%	17.0%	12.5%	13.7%	12.7%	13.2%
Application services	34.3%	34.3%	33.9%	37.8%	36.2%	36.3%	35.8%
Infrastructure services	10.0%	11.4%	11.6%	12.5%	13.3%	14.0%	13.8%
BPO services	13.4%	12.7%	14.0%	13.3%	12.8%	12.7%	13.7%
Geography							
US	61.9%	60.6%	59.3%	57.8%	59.6%	57.3%	54.3%
Europe	22.3%	21.4%	25.7%	28.8%	28.6%	29.2%	30.2%
AsiaPac	15.8%	18.0%	15.0%	13.3%	11.8%	13.5%	15.5%
Verticals							
BFSI	n.a.	25.6%	24.3%	n.a.	22.8%	27.2%	27.5%
Manufacturing, Hi-Tech	n.a.	34.2%	33.1%	n.a.	31.3%	29.7%	28.9%
Telecom	n.a.	17.3%	18.5%	n.a.	16.9%	16.2%	17.2%
Retail	n.a.	5.7%	7.7%	n.a.	12.0%	10.6%	9.4%
Media and Entertainment	n.a.	6.1%	6.1%	n.a.	5.9%	5.9%	5.6%
Life Sciences	n.a.	3.4%	3.4%	n.a.	3.5%	4.0%	4.5%
Others	n.a.	7.8%	7.0%	n.a.	7.6%	6.4%	6.8%

Source: Company Reports

Figure 6. Key client metrics

	1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07
Client relationships							
No. of 1 mn \$ clients	140	130	131	133	143	145	147
No. of 5 mn \$ clients	29	33	34	35	41	46	48
No. of 10 mn \$ clients	16	16	14	15	18	22	25
No. of 20 mn \$ clients	5	6	6	6	8	8	10
No. of 50 mn \$ clients	2	2	2	2	2	2	3
Client concentration							
Top 5 Clients	29.9%	28.7%	28.3%	28.1%	28.7%	29.7%	29.2%
Top 10 Clients	39.0%	37.8%	37.6%	37.2%	38.2%	39.0%	38.5%
Top 20 Clients	50.2%	48.6%	48.1%	48.9%	49.9%	51.5%	50.9%

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 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 over 400 clients across verticals and a workforce of 32,000.

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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 for 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 for the next few years. We forecast a 24.3% revenue CAGR and 21.2% EPS CAGR for FY06-09. The stock has underperformed the Sensex for the past two quarters. A forecast dividend yield of 2.9% and high cash per share of Rs58 should limit the downside for this stock.

Valuation

Our 12-month target price is Rs385 based on 19x average FY08-09E EPS. We value HCL Tech relative to Satyam, which is similar to HCL Tech in terms of revenue. We expect a 21.2% CAGR in earnings for the next three years and believe the stock should trade toward the high 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 10% discount to our target multiple of 21x for Satyam primarily because of lower growth and return ratios compared with Satyam. We believe P/E remains the most appropriate valuation measure given HCL Tech's past profitability and future earnings visibility. Our target price is also supported by average FY08-09E Price/Sales of 3.1x, which is within the stock's historical trading range of 2-4x.

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.

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Appendix A-1

Analyst Certification

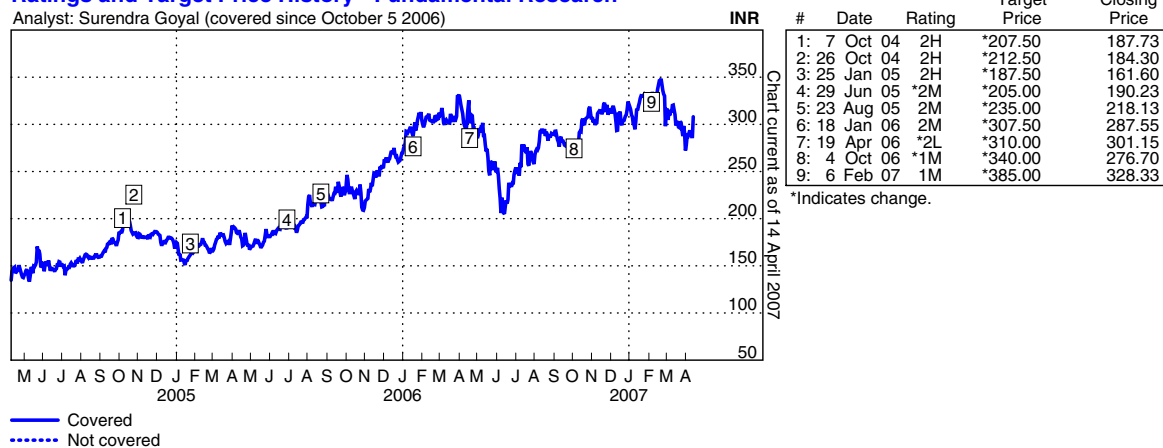
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HCL Technologies (HCLT.BO)

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Analyst: Surendra Goyal (covered since October 5 2006)



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