

## Company Flash

17 January 2008 | 8 pages

# HCL Technologies (HCLT.BO)

## Buy: In-line 2QFY08 Results

- In-line quarter** — Revenue for the quarter was \$461m (exp: \$462m), growth of 7.5% qoq. Net profit came in at Rs3.11 b (exp: Rs3.08 b), an increase of 9.6% qoq. On margins, HCL Tech did well to absorb the negative impact of the customer summit related costs and bonus amendment adjustment.
- IT Services up 8.4%; flat margins** — IT Services did well again with a growth of 8.4% qoq. Volumes increased ~7.4% qoq while pricing was up ~2% sequentially. EBIT margins improved slightly qoq to ~18.1%.
- Infrastructure services on a strong footing; BPO muted** — Infrastructure services continue to deliver strong growth – in Q2FY08, the business grew 9% qoq to \$71m. EBIT margins remained stable at ~17%. BPO business had a relatively muted quarter with revenues remaining stable at \$55m – this was in-line with expectations. EBIT margins in this business were stable at ~20%.
- US grows 9%, BFSI grows 9.3%** — HCL Tech's US revenues increased 9% qoq while BFSI revenues were up 9.3% qoq – delivering a strong performance in a quarter when most of the investor concerns center around these two segments.
- Hiring strong; outlook decent** — In IT Services, HCL Tech has added ~34% employees to its rolls in the trailing 12 months highlighting management's confidence on the demand outlook ahead. Management indicated that deal flow continues to remain strong.
- 13x FY09E and ~3% dividend yield; maintain Buy (1M)** — HCL Tech continues to deliver; all businesses have had another decent quarter. The stock trades at ~13x FY09E and present price implies ~3% dividend yield. Maintain Buy (1M).

<b>Buy/Medium Risk</b>	<b>1M</b>
Price (17 Jan 08)	Rs273.85
Target price	Rs365.00
Expected share price return	33.3%
Expected dividend yield	2.9%
<b>Expected total return</b>	<b>36.2%</b>
Market Cap	Rs181,913M
	US\$4,639M

### 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)	(%)	(%)
2006A	7,091	10.46	9.4	26.2	4.3	18.1	2.9
2007A	12,577	18.43	76.2	14.9	3.6	27.7	2.9
2008E	12,309	18.07	-1.9	15.2	3.0	22.2	2.9
2009E	14,509	21.30	17.9	12.9	2.6	22.3	2.9
2010E	15,743	23.12	8.5	11.8	2.3	21.2	2.9

Source: Powered by dataCentral

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<sup>1</sup>Citigroup Global Markets India Private Limited

### Other Key Highlights

- Growth was strong across verticals with Life Sciences and Media reporting 15%+ qoq growth while BFSI and Retail recorded ~9% qoq growth.
- Among geographies, US recorded 9% qoq growth - despite the holiday season.
- Company announced three key relationships/deal wins - a) new multi-year, multi-service large deal from Merck; b) strategic technology partnership with Quest Diagnostics and c) strategic partnership with Misys.
- HCL Tech has added ~26% to its workforce over the last 4 quarters; in IT Services the addition is ~35% while in infrastructure services it is 55%.
- Attrition decreased across all three business segments. Attrition in IT Services was 15.5% for the quarter.
- Number of US\$1m+ clients increased to 175 (up by 9 over last quarter). Over 68% of HCL clients now belong to US\$1m+ category.
- Company had unrealized gains of Rs800m on its treasury investments at the end of last quarter.
- Hedge position at the end of Q2FY08 was \$2.3b, GBP59m and EUR62m. Company had forex gains of Rs.58 m during the quarter.

Figure 1. Key Financials

Rs mn	2Q07	1Q08	2Q08	QoQ	YoY
<b>Revenue (US\$ m)</b>	<b>331</b>	<b>429</b>	<b>461</b>	<b>7.5%</b>	<b>39.3%</b>
<b>Revenue</b>	<b>14,651</b>	<b>17,092</b>	<b>18,166</b>	<b>6.3%</b>	<b>24.0%</b>
Cost of revenue	9,107	10,763	11,258	4.6%	23.6%
Gross profit	5,544	6,329	6,908	9.1%	24.6%
Gross margin	37.8%	37.0%	38.0%	100bp	19bp
Operating expenses	2,303	2,690	3,023	12.4%	31.3%
<b>EBITDA</b>	<b>3,241</b>	<b>3,639</b>	<b>3,885</b>	<b>6.8%</b>	<b>19.9%</b>
<b>EBITDA margin</b>	<b>22.1%</b>	<b>21.3%</b>	<b>21.4%</b>	<b>10bp</b>	<b>-74bp</b>
Depreciation and amortization	623	686	724	5.5%	16.2%
<b>EBIT</b>	<b>2,618</b>	<b>2,953</b>	<b>3,161</b>	<b>7.0%</b>	<b>20.7%</b>
<b>EBIT margin</b>	<b>17.9%</b>	<b>17.3%</b>	<b>17.4%</b>	<b>12bp</b>	<b>-47bp</b>
Other income	481	504	542	7.5%	12.7%
Profit before tax	3,099	3,457	3,703	7.1%	19.5%
Income tax expense	206	346	355	n.a.	72.3%
Income from operations	2,893	3,111	3,348	7.6%	15.7%
Affiliates/Minority	-30	-28	-21	n.a.	n.a.
Net income - recurring	2,863	3,083	3,327	7.9%	16.2%
Non-cash charges for ESOPs	-266	-250	-222	n.a.	n.a.
<b>Net profit</b>	<b>2,597</b>	<b>2,833</b>	<b>3,105</b>	<b>9.6%</b>	<b>19.6%</b>
EPS - basic	4.41	4.65	5.01	7.9%	13.6%
EPS - diluted	4.19	4.53	4.88	7.7%	16.4%

Source: Company Reports

Figure 2. Segment Financials

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08
<b>HCL Tech - consolidated</b>						
Revenue (Rs mn)	13,794	14,651	15,771	16,120	17,094	18,166
Change - qoq	10.0%	6.2%	7.6%	2.2%	6.0%	6.3%
EBITDA margin	21.7%	22.1%	23.3%	21.6%	21.3%	21.4%
Change - qoq	-78bp	45bp	113bp	-170bp	-26bp	10bp
<b>IT services</b>						
Revenue (Rs mn)	10,206	10,739	11,421	11,505	12,316	13,199
Change - qoq	9.7%	5.2%	6.4%	0.7%	7.0%	7.2%
EBITDA margin	22.3%	22.9%	23.7%	21.8%	21.4%	21.6%
Change - qoq	-98bp	62bp	85bp	-194bp	-39bp	20bp
<b>Infrastructure services</b>						
Revenue (Rs mn)	1,825	2,053	2,186	2,417	2,580	2,783
Change - qoq	16.6%	12.5%	6.5%	10.6%	6.7%	7.9%
EBITDA margin	17.6%	17.5%	17.6%	16.7%	16.8%	16.8%
Change - qoq	14bp	-10bp	13bp	-94bp	15bp	-1bp
<b>BPO services</b>						
Revenue (Rs mn)	1,763	1,859	2,164	2,198	2,198	2,184
Change - qoq	5.4%	5.4%	16.4%	1.6%	0.0%	-0.6%
EBITDA margin	22.4%	22.9%	26.5%	25.8%	26.1%	26.0%
Change - qoq	-38bp	51bp	361bp	-77bp	32bp	-11bp

Source: Company Reports

Figure 3. Manpower and Execution Metrics

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08
<b>Total manpower</b>	36,402	38,317	40,149	42,017	45,642	47,954
Net addition	3,776	1,915	1,832	1,868	3,625	2,312
<b>A. Software services</b>						
Total manpower	21,943	22,523	23,796	26,326	29,157	30,484
Delivery	19,657	20,004	21,013	23,160	25,667	26,778
Support	2,286	2,519	2,783	3,166	3,490	3,706
<b>B. BPO services</b>						
Total manpower	11,062	12,181	12,354	11,252	11,262	11,865
Delivery	10,340	11,343	11,407	10,212	10,220	10,804
Support	722	838	947	1,040	1,042	1,061
<b>C. Infrastructure services</b>						
Total manpower	3,397	3,613	3,999	4,439	5,223	5,605
Delivery	2,867	3,071	3,418	3,794	4,543	4,894
Support	530	542	581	645	680	711
<b>Efforts - IT services</b>						
Billed	42,213	46,264	48,053	51,162	55,754	59,845
- offshore	30,593	33,986	34,965	37,129	41,187	44,660
- onsite	11,620	12,278	13,088	14,033	14,567	15,185
Unbilled	10,055	12,177	12,361	11,943	12,813	15,091
Trainees	5,853	3,414	3,351	3,774	6,186	5,427
<b>Utilization - IT services</b>						
Offshore	67.9%	69.4%	69.8%	71.1%	69.2%	69.1%
Offshore ex trainees	77.7%	74.6%	74.8%	76.7%	77.2%	75.5%
Onsite	92.2%	95.2%	95.6%	95.6%	95.8%	96.4%
<b>Revenue Mix - IT services</b>						
- offshore	48.2%	49.0%	47.7%	47.9%	49.4%	50.5%
- onsite	51.8%	51.0%	52.3%	52.1%	50.6%	49.5%
<b>Attrition</b>						
IT services - LTM	16.5%	17.8%	17.5%	17.3%	16.5%	15.5%
BPO - quarterly	18.5%	19.9%	19.5%	17.5%	14.2%	12.3%
Infrastructure services - LTM	13.1%	16.8%	16.4%	17.3%	15.9%	15.6%

Source: Company Reports

**Figure 4. Revenue Mix**

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08
<b>Service Offering</b>						
R&D and Engg services	24.0%	24.2%	23.3%	23.9%	24.8%	24.3%
Enterprise Application services	13.7%	12.7%	13.2%	12.0%	11.8%	12.0%
Application services	36.2%	36.3%	35.8%	35.5%	35.5%	35.9%
Infrastructure services	13.3%	14.0%	13.8%	15.0%	15.1%	14.9%
BPO services	12.8%	12.7%	13.7%	13.6%	12.8%	13.0%
<b>Geography</b>						
US	59.6%	57.3%	54.3%	56.1%	54.2%	55.0%
Europe	28.6%	29.2%	30.2%	29.7%	30.8%	29.7%
AsiaPac	11.8%	13.5%	15.5%	14.2%	15.0%	15.3%
<b>Verticals</b>						
BFSI	22.8%	27.2%	27.5%	28.7%	28.7%	29.2%
Manufacturing, Hi-Tech	31.3%	29.7%	28.9%	28.7%	30.0%	28.5%
Telecom	16.9%	16.2%	17.2%	17.2%	16.3%	16.1%
Retail	12.0%	10.6%	9.4%	9.2%	8.7%	8.8%
Media and Entertainment	5.9%	5.9%	5.6%	5.6%	5.5%	5.9%
Life Sciences	3.5%	4.0%	4.5%	4.9%	5.2%	5.6%
Others	7.6%	6.4%	6.8%	5.7%	5.6%	5.9%

Source: Company Reports

**Figure 5. Client Metrics**

	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08
<b>Client relationships</b>						
No. of 1 mn \$ clients	143	145	147	156	166	175
No. of 5 mn \$ clients	41	46	48	52	55	59
No. of 10 mn \$ clients	18	22	25	26	27	29
No. of 20 mn \$ clients	8	8	10	13	13	15
<b>Client concentration</b>						
Top 5 Clients	28.7%	29.7%	29.2%	28.4%	27.8%	27.2%
Top 10 Clients	38.2%	39.0%	38.5%	38.2%	38.0%	37.8%
Top 20 Clients	49.9%	51.5%	50.9%	51.1%	50.7%	50.5%

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 one of the 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 240 clients across verticals, and a workforce of more than 45,000.

## 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 sixteen 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 22% revenue CAGR and 8% EPS CAGR (20% CAGR in EBITDA) for FY07-10E.

## Valuation

Our 12-month target price is Rs365 based on 17x FY09E EPS. We value HCL Tech based on historical P/E and cross-check our valuation against Satyam's, which is similar to HCL Tech on revenue. We expect a 20% CAGR in EBITDA and 8% for EPS for the next three years, and believe the stock should trade towards the average 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 equates to an ~11% discount to our target multiple of 19x for Satyam primarily because of HCL Tech's slower growth and return ratios. We believe P/E remains the most appropriate valuation measure given HCL Tech's past profitability and future earnings visibility.

## Risks

Although our quantitative risk-rating system suggests Low Risk, we rate HCL Tech as Medium Risk given the similar risk rating for Satyam. 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/GBP; (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

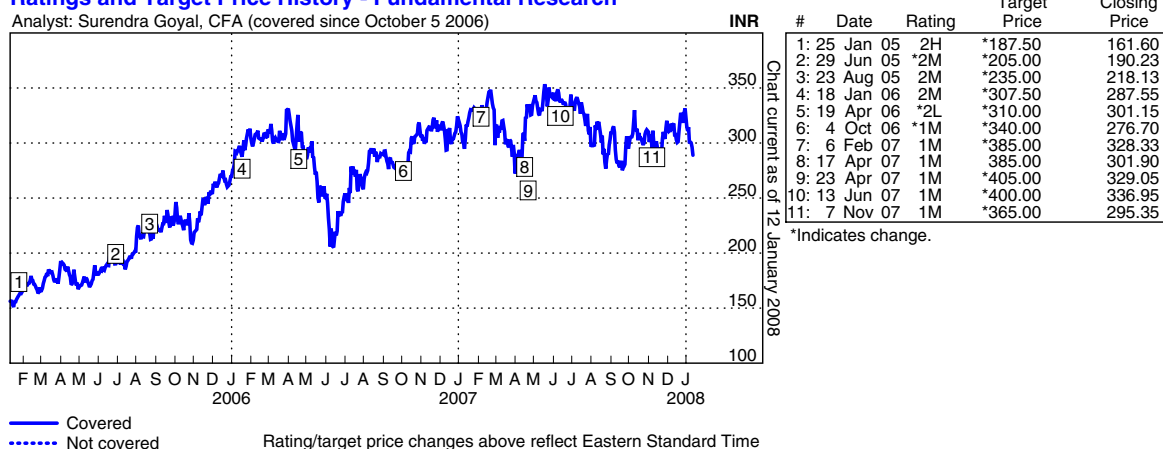
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Analyst: Surendra Goyal, CFA (covered since October 5 2006)



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