

## HCL Technologies

Q4FY09 Update/Rating change

26 August 2009

## Hold

Target Price: Rs252

CMP: Rs307\*

Downside: 18%

\*as on 25 August 2009

## Positive surprise

**HCL Tech beat estimates on the back of higher-than-expected ramp up in new deals (US\$63mn in Q4 vs. its guidance of US\$43mn), thereby resulting in 182bp higher utilization and 90bp QoQ increase in EBITDA margin. Forex gains of Rs0.69bn and lower depreciation and amortization costs led to a 51% QoQ PAT growth.**

- **Estimates revised, downgrade to Hold on steep valuations:** We have raised EPS estimates for FY10E and FY11E by 5.6% and 4% respectively. However we downgrade the stock to Hold on steep valuations with a price target of Rs252 (Rs220 earlier) – refrain from outright Sell rating as outlook on the business continues to improve.
- **Broad-based growth across most verticals and horizontals:** The growth was broad-based across most verticals, horizontals and geographies. Infrastructure services vertical was the star performer during the quarter posting a 25.5% QoQ growth, followed by custom application development at 12.5%.
- **Management cautious on weak deal environment:** The management maintained caution on the back of a weak deal environment with no signs of improvement. We believe this could hamper future growth. However, HCL Tech's revenue visibility from new deals won in FY09 is comforting.

## Nitin Padmanabhan

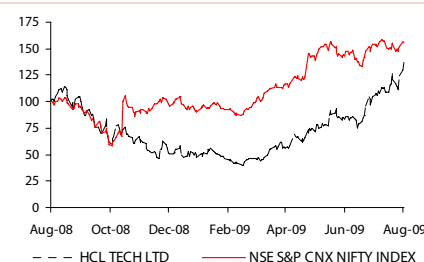
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## Key Data

Bloomberg Code	HCLT IN
Reuters Code	HCLT.BO
Current Shares O/S (mn)	670.3
Diluted Shares O/S(mn)	670.3
Mkt Cap (Rsbn/USDbn)	205.9/4.2
52 Wk H / L (Rs)	320/87
Daily Vol. (3M NSE Avg.)	1,393,433
Face Value (Rs)	2

USD = Rs48.8

## One Year Indexed Stock Performance



## Price Performance (%)

	1M	6M	1Yr
HCL Tech.	31.0	210.0	33.3
NIFTY	2.0	67.3	7.4

Source: Bloomberg, Centrum Research  
\*as on 25 August 2009

Y/E June (Rsbn)	Q4FY09	Q4FY08	YoY (%)	Q3FY09	QoQ (%)	Q4FY09E	Variance (%)
<b>Net sales</b>	<b>29.08</b>	<b>21.69</b>	<b>34.1</b>	<b>28.62</b>	<b>1.61</b>	<b>28.32</b>	<b>2.7</b>
Employee costs	18.13	12.91		18.01		18.00	
% of sales	62.3	59.5		62.9		63.6	
SG&A	4.5	3.69		4.50		4.33	
% of sales	15.5	17.0		15.7		15.3	
<b>Operating profit</b>	<b>6.45</b>	<b>5.09</b>	<b>26.8</b>	<b>6.11</b>	<b>5.62</b>	<b>5.99</b>	<b>7.7</b>
<b>OPM (%)</b>	<b>22.2</b>	<b>23.4</b>	<b>(120)bp</b>	<b>21.3</b>	<b>90bp</b>	<b>21.2</b>	<b>100bp</b>
Depreciation and amortization	1.20	0.85		1.42		1.35	
EBT	5.25	4.24		4.69		4.64	
Other income (net)	(1.01)	(2.62)		(2.04)		(1.44)	
<b>PBT</b>	<b>4.24</b>	<b>1.61</b>	<b>162.8</b>	<b>2.65</b>	<b>60.06</b>	<b>3.20</b>	<b>32.6</b>
Provision for tax	0.94	0.20		0.49		0.68	
-effective tax rate	22.0	12.6		18.3		21.4	
Minority share in profit / loss	0.00	0.00		0.02		0.00	
<b>PAT (reported)</b>	<b>3.30</b>	<b>1.41</b>	<b>134.0</b>	<b>2.18</b>	<b>51.35</b>	<b>2.51</b>	<b>31.3</b>
<b>NPM (%)</b>	<b>11.4</b>	<b>6.5</b>		<b>7.6</b>		<b>8.9</b>	

Source: Company, Centrum Research

Y/E June (Rsbn)	Rev	YoY (%)	EBITDA	EBITDA (%)	Adj PAT	YoY (%)	Fully DEPS	RoE (%)	RoCE (%)	P/E (x)	EV/EBITDA (x)
FY07	60.34	37.5	13.37	22.2	13.55	75.1	20.3	29.9	29.9	15.1	13.6
FY08	76.39	26.6	16.94	22.2	11.25	(17.0)	16.8	22.0	27.4	18.3	9.8
FY09	106.09	38.9	23.25	21.9	12.79	13.7	19.1	23.5	22.9	16.1	9.1
FY10E	116.90	10.2	24.45	20.9	11.14	(12.9)	16.6	18.7	19.7	18.5	8.5
FY11E	124.59	6.6	23.41	18.8	14.03	25.9	20.9	21.2	18.6	14.7	9.4

Source: Company, Centrum Research Estimate

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### Estimates revised marginally

We have raised our EPS estimates marginally to factor in higher other income, 2% increase in effective tax rate and build-in the guidance for the impact from cash flow hedges. Lower ramp downs in FY10E could translate into higher upsides as we have estimated incremental dollar revenues of only US\$29mn to factor in possibilities of ramp downs and project closures vs. expected incremental revenues of US\$270mn. We are however cautious on margins as higher transition costs from new deals could be an overhang.

#### Exhibit 1: Revised estimates

Y/E June (Rsbn)	FY10E			FY11E		
	Earlier	Revised	Change %	Earlier	Revised	Change %
Revenues	116.3	116.9	0.5	125.5	124.6	(0.7)
EBIDTA	24.0	24.5	1.9	23.3	23.4	0.4
EBIDTA(%)	20.6	20.9	28bp	18.6	18.8	21bp
Adj. PAT	10.6	11.1	5.6	13.5	14.0	4.0
FDEPS	15.7	16.6	5.6	20.1	20.9	4.0

Source: Centrum Research Estimate

### Management stance continues to be cautious

The management continues to maintain a cautious stance as it believes that the deal environment is still weak and would only improve after two quarters. The management said deals (excluding government orders) have declined from US\$8bn to US\$2bn during the April-June 2009 quarter and July and August have also been subdued

### Downgrade to Hold on steep valuations, target price revised

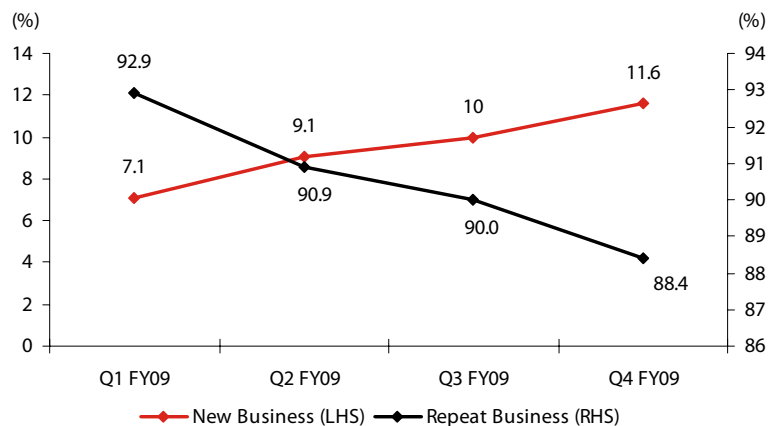
We downgrade our rating to Hold on steep valuations at 14.7x FY11E EPS of Rs20.9 (stock is up 75% post our previous recommendation). However we believe the company's fundamentals continue to improve and refrain from an outright Sell rating on the stock. We have revised our target price to Rs252 (Rs220 earlier) on the back of a 4% upgrade in our FY11E EPS. We also believe HCL Tech's discount to Infosys Technologies would narrow. The company is expected to report 25.9% EPS growth in FY11E as the impact from cash flow hedges wears off. This would be double Infosys' EPS growth (the overhang of higher tax rates would stym Infosys's EPS growth) and hence we raise our target multiple to 12x FY11E from 11x earlier.

### Q4 FY09 review

#### Revenue outperformance on higher-than-expected ramp ups

HCL Tech reported a 7.6% QoQ revenue growth in dollar terms and 1.6% in INR ahead of our estimates of 2.7% growth in dollar terms and 1.1% decline in INR terms. This outperformance was largely on account of higher-than-expected ramp up in new deals at US\$63mn vs US\$43mn estimated. Cross-currency gains contributed 3.7% to growth in dollar terms. Adjusted for these cross-currency gains, HCL Tech would have grown 3.9% in dollar terms QoQ.

#### Exhibit 2: Revenues from new business rising

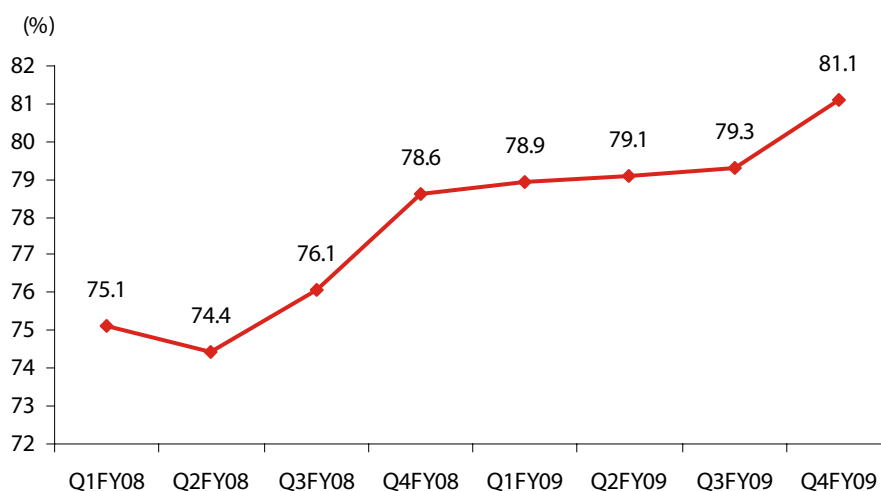


Source: Company, Centrum Research

### Higher utilization aids margins

The company recorded 90bp increase in operating margin on the back of 182bp increase in utilization levels led by strong volumes. The management indicated that utilization would be maintained at higher levels as it increased its headcount on a just in time basis.

#### Exhibit 3: Utilization on an uptrend - likely to maintained at the higher end



Source: Company, Centrum Research

The core software segment continued to have negative headcount additions (number of employees down by 538) and reported 176bp increase in margin on the back of higher utilization. The infrastructure services segment grew by 25.4% QoQ. However, margins declined 261bp on higher transitioning costs for new deals. The BPO segment grew by 3.9% in dollar terms. The management guided that it would take at least 18 months before the BPO segment exhibits sustainable growth.

### Higher PAT led by forex gains, lower depreciation and amortization

PAT grew 51% QoQ on the back of Rs0.69bn forex gain vs. Rs0.76bn forex loss the previous quarter. Depreciation costs were lower as the company adjusted for capitalized assets that were erroneously capitalized ahead of time.

### Broad-based growth across most parameters

#### Exhibit 4: Top 20 clients would have grown 8% QoQ if adjusted for LTM\* reporting

Top 10 and 20 clients would have grown by 6% and 8% respectively if adjusted for LTM reporting

Growth (%)	Q1FY09	Q2 FY 09	Q3 FY 09	Q4 FY 09
Top 5 Clients	(2.1)	(1.8)	(1.0)	(2.4)
Top 10 Clients	(1.7)	(2.8)	0.3	(2.5)
Top 20 Clients	(1.5)	(0.5)	0.4	(0.8)

\*LTM: Last 12 months

Source: Company, Centrum Research

#### Exhibit 5: Robust growth across most verticals

Media publishing and entertainment grew by a robust 20.5% during the quarter

Growth (QoQ %)	Q1FY09	Q2 FY 09	Q3 FY 09	Q4 FY 09
Banking, FS & Insurance (BFSI)	(2.7)	2.1	(6.0)	13.1
Hi-tech - Manufacturing	4.2	(1.0)	11.4	9.7
Telecom	0.7	(3.0)	(15.5)	11.1
Retail	(2.2)	(4.8)	(1.1)	2.9
Media Publishing & Entertainment (MPE)	(1.6)	(0.5)	0.3	20.5
Life Sciences	7.4	1.3	17.8	9.3
Others	19.3	(24.0)	81.3	(12.7)

Source: Company, Centrum Research

**Exhibit 6: Infrastructure services – the star performer for the quarter**

Enterprise application services grew on the back of new deal ramp ups. However the management indicated that the business environment was challenging

Growth(QoQ %)	Q1FY09	Q2 FY 09	Q3 FY 09	Q4 FY 09
Enterprise Application Services	1.1	16.2	116.3	3.6
Engineering and R&D Services	(1.4)	(1.0)	(5.5)	(5.1)
Industry Solutions (Custom Application)	(1.0)	(6.9)	(4.8)	12.5
Infrastructure Services	4.1	6.5	1.0	25.4
BPO Services	1.0	11.2	(11.0)	4.4

Source: Company, Centrum Research

**Exhibit 7: Asia Pac and Europe deliver robust growth**

Growth (QoQ %)	Q1FY09	Q2 FY 09	Q3 FY 09	Q4 FY 09
US	0.0	5.8	12.6	3.9
Europe	(1.2)	(4.3)	12.4	11.1
Asia Pacific	3.1	(4.5)	(4.0)	18.9

Source: Company, Centrum Research

## Financials

### Exhibit 8: Income Statement

Y/E June (Rsbn)	FY07	FY08	FY09	FY10E	FY11E
<b>Net Sales</b>	<b>60.34</b>	<b>76.39</b>	<b>106.09</b>	<b>116.90</b>	<b>124.59</b>
-Growth (%)	37.5	26.6	38.9	10.2	6.6
Direct Cost	37.59	46.88	65.48	74.82	81.89
% of sales	62.3	61.4	61.7	64.0	65.7
Selling General & Admin.	9.37	12.58	17.36	17.62	19.29
% of sales	15.5	16.5	16.4	15.1	15.5
Other expenses	-	-	-	-	-
% of sales	-	-	-	-	-
<b>EBIDTA</b>	<b>13.37</b>	<b>16.94</b>	<b>23.25</b>	<b>24.45</b>	<b>23.41</b>
-EBIDTA margin (%)	22.2	22.2	21.9	20.9	18.8
Depreciation	2.53	3.03	4.49	5.04	5.13
EBIT	10.84	13.91	18.76	19.41	18.28
Interest expenses	-	-	0.82	1.36	0.81
PBT from operations	10.84	13.91	17.94	18.05	17.47
Other non operating income	4.26	(1.37)	(2.61)	(4.46)	(0.36)
<b>PBT</b>	<b>15.10</b>	<b>12.54</b>	<b>15.33</b>	<b>13.59</b>	<b>17.11</b>
-PBT margin (%)	25.0	16.4	14.5	11.6	13.7
Provision for tax	1.49	1.27	2.54	2.45	3.08
Effective tax rate (%)	9.8	10.1	16.6	18.0	18.0
<b>Net profit</b>	<b>13.61</b>	<b>11.27</b>	<b>12.79</b>	<b>11.14</b>	<b>14.03</b>
-Growth (%)	75.1	(17.3)	13.5	(12.9)	25.9
-Net profit margin (%)	22.6	14.7	12.1	9.5	11.3

Source: Company, Centrum Research Estimate

### Exhibit 9: Balance Sheet

Y/E June (Rsbn)	FY07	FY08	FY09	FY10E	FY11E
Share capital	1.33	1.33	1.34	1.34	1.34
Reserves & surplus	48.82	50.85	55.50	61.30	68.59
Total shareholder's fund	50.15	52.18	56.84	62.64	69.93
Loan fund	-	-	29.77	24.77	14.77
Deferred tax liability	-	-	-	-	-
Minority interest	0.15	0.06	0.02	0.02	0.02
<b>Total capital employed</b>	<b>50.29</b>	<b>52.23</b>	<b>86.63</b>	<b>87.42</b>	<b>84.72</b>
Gross block	19.84	25.84	31.84	35.67	40.38
Accumulated depreciation	11.35	14.06	17.60	21.62	26.23
Net Block	8.50	11.78	14.46	14.29	14.41
Capital WIP	2.00	1.54	1.40	1.54	1.54
Net fixed assets	10.50	13.32	15.86	15.83	15.95
Intangible Assets	8.06	9.59	45.33	45.33	45.33
Investments	19.36	20.88	0.60	0.60	0.60
Other Assets	2.35	5.06	8.61	6.98	6.98
Goodwill on consolidation	-	-	-	-	-
Cash and bank	3.59	3.84	18.76	22.25	20.90
Inventories	-	-	-	-	-
Sundry debtors	12.28	18.93	27.08	29.84	31.81
Other current assets	7.12	8.71	10.70	10.70	10.70
Total current assets	22.98	31.48	56.54	62.79	63.41
Current liabilities and provisions	11.66	22.15	32.68	36.46	39.91
Net current assets	11.32	9.34	23.87	26.33	23.50
Other liabilities	1.29	5.96	7.63	7.63	7.63
Deferred tax assets	-	-	-	-	-
<b>Total assets</b>	<b>50.29</b>	<b>52.23</b>	<b>86.63</b>	<b>87.42</b>	<b>84.72</b>

Source: Company, Centrum Research Estimate

### Exhibit 10: Cash flow

Y/E June (Rsbn)	FY07	FY08	FY09E	FY10E	FY11E
<b>Cash flow from operating</b>					
Pre tax profit from operations	10.84	13.91	17.94	18.05	17.47
Depreciation	2.53	3.03	4.49	5.04	5.13
Interest expenses	-	-	0.82	1.36	0.81
Other non cash charges	(0.03)	(0.11)	(0.04)	-	-
Operating profit before WC chg	13.34	16.83	23.20	24.45	23.41
Working capital adjustments	(2.72)	6.89	2.08	1.03	1.48
Direct tax paid	(1.49)	(1.27)	(2.54)	(2.45)	(3.08)
<b>Net cash generated from operating</b>	<b>9.14</b>	<b>22.46</b>	<b>22.74</b>	<b>23.03</b>	<b>21.81</b>
<b>Cashflow from investing activities</b>					
Capex	(3.95)	(7.38)	(42.77)	(5.01)	(5.25)
Investments	1.37	(2.89)	17.67	(4.45)	(0.36)
Other Assets	(1.34)	(2.72)	(3.55)	1.63	-
Acquisition	-	-	-	-	-
Int./dividends received/sale of sec.	-	-	-	-	-
<b>Net cash gen. from investing</b>	<b>(3.92)</b>	<b>(12.99)</b>	<b>(28.64)</b>	<b>(7.83)</b>	<b>(5.61)</b>
<b>Cash flow from financing</b>					
Proceeds from sh. Cap. & premium	0.68	0.00	0.01	-	-
Borrowings/(Repayments)	(0.08)	-	29.77	(5.00)	(10.00)
Interest paid	-	-	(0.82)	(1.36)	(0.81)
Dividend paid	(2.66)	(6.89)	(6.14)	(5.35)	(6.73)
Addition to reserves on amalgamation	(1.98)	(2.32)	(1.99)	-	-
<b>Net cashflow from financing</b>	<b>(4.04)</b>	<b>(9.22)</b>	<b>20.83</b>	<b>(11.71)</b>	<b>(17.55)</b>
<b>Net cash increase/(decrease)</b>	<b>1.18</b>	<b>0.25</b>	<b>14.92</b>	<b>3.49</b>	<b>(1.35)</b>

Source: Company, Centrum Research Estimate

### Exhibit 11: Key Ratios

Y/E June	FY07	FY08	FY09	FY10E	FY11E
<b>Profitability ratios (%)</b>					
EBIDTA margin	22.2	22.2	21.9	20.9	18.8
PBIT margin	18.0	18.2	17.7	16.6	14.7
PBT margin	25.0	16.4	14.5	11.6	13.7
PAT margin	22.6	14.7	12.1	9.5	11.3
<b>Return ratios (%)</b>					
ROCE	29.9	27.4	22.9	19.7	18.6
ROIC	39.7	45.6	33.0	24.1	23.5
ROE	29.9	22.0	23.5	18.7	21.2
<b>Turnover Ratios</b>					
Asset turnover ratio (x)	1.2	1.5	1.2	1.3	1.5
Working capital cycle (days)	55.1	49.4	57.1	78.4	73.0
Average collection period (days)	74.3	90.5	104.3	93.2	93.2
Average payment period (days)	90.6	136.0	155.3	144.0	144.0
<b>Per share (Rs)</b>					
Basic EPS	20.3	16.8	19.1	16.6	21.0
Fully diluted EPS	20.3	16.8	19.1	16.6	20.9
Book value	75.4	78.4	84.8	93.4	104.3
<b>Solvency Ratio</b>					
Debt-equity	0.0	0.0	0.5	0.4	0.2
Interest coverage ratio	0.0	0.0	22.9	14.2	22.5
<b>Valuation (x)</b>					
P/E	15.1	18.3	16.1	18.5	14.7
P/BV	4.1	3.9	3.6	3.3	2.9
EV/EBIDTA	13.6	9.8	9.1	8.5	9.4
EV/Sales	3.0	2.2	2.0	1.8	1.8
M-cap/Sales	3.4	2.7	1.9	1.8	1.7

Source: Company, Centrum Research Estimate

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### Key to Centrum Investment Rankings

**Buy:** Expected to outperform Nifty by >15%, **Accumulate:** Expected to outperform Nifty by +5 to 15%, **Hold:** Expected to outperform Nifty by -5% to +5%, **Reduce:** Expected to underperform Nifty by 5 to 15%, **Sell:** Expected to underperform Nifty by >15%

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