



HCL Technologies

STOCK INFO.	BLOOMBERG
BSE SENSEX: 14,115	HCLT IN
	REUTERS CODE
S&P CNX: 4,077	HCLT.BO

16 January 2007

Neutral

Previous Recommendation: Neutral

Rs639

Equity Shares (m)	324.4
52-Week Range	707/362
1,6,12 Rel. Perf. (%)	-1/-21/-43
M.Cap. (Rs b)	207.3
M.Cap. (US\$ b)	4.6

YEAR	SALES	PAT*	EPS*	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
6/06A	43,882	7,732	23.9	24.2	26.7	5.1	19.7	21.0	4.3	19.4
6/07E	60,359	10,995	33.4	42.2	19.1	4.7	25.7	28.3	3.1	13.8
6/08E	79,602	13,292	39.5	20.9	16.2	4.2	27.7	31.1	2.3	10.5

* Before extraordinary and ESOP charges

- 2QFY07 operational results in line, other income drives higher PAT: HCL Tech posted Rs14.7b in revenue, up 6.2% QoQ supported by growth of 5.2% in software services, 12.5% in infrastructure services and 5.4% in BPO. Margins improved 45bp despite negative impact of rupee and increase in SG&A due to better price realization and utilization rates. Net profit (before ESOP) grew 14.5% QoQ due to high other income and lower effective tax rate.
- Pricing environment appears to be on a favorable trend: HCL Tech is witnessing increase in pricing to the extent of 3-5% for contract renewals (v/s minuscule or nil price hikes until the previous quarter) and up to 10% hike in new contracts. We expect realization improvement to act as a significant margin positive over next few quarters.
- High attrition likely to keep wage inflation higher than industry: Attrition rates have risen in all business segments; we believe the high attrition rates would compel the company to offer attractive wage structures as well as result in a greater number of employees being included in its stock option plan.
- Outlook: Given the improved revenue and margin outlook, higher other income for 3QFY07 and lower tax rate, we are upgrading our EPS (after ESOP) estimates by 4.4%, 2.2% and 2.1% to Rs30.3, Rs36.5 and Rs44 for FY07E, FY08E and FY09E respectively. The stock trades at 17.5x FY08E and 14.5x FY09E EPS estimates (after ESOP). Given the increased visibility for revenue growth and margins over next few quarters; we would like to see consistency in revenue & margins in the coming quarters to warrant any significant re-rating. We maintain **Neutral**.

QUARTERLY PERFORMANCE

Y/E JUNE	(Rs Million)									
	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Revenues	9,709	10,542	11,220	12,538	13,794	14,651	15,479	16,434	43,882	60,359
Q-o-Q Change (%)	4.7	8.6	6.4	11.7	10.0	6.2	5.7	6.2	30.5	37.5
Direct Expenses	6,093	6,564	6,979	7,946	8,709	9,107	9,575	10,217	27,571	37,608
Sales, General & Admin. Expenses	1,458	1,601	1,743	1,777	2,098	2,303	2,372	2,501	6,582	9,274
Operating Profit	2,158	2,377	2,498	2,815	2,987	3,241	3,532	3,716	9,729	13,476
Margins (%)	22.2	22.5	22.3	22.5	21.7	22.1	22.8	22.6	22.2	22.3
Other Income	124	143	255	56	290	481	225	225	573	1,221
Depreciation	447	493	530	562	556	623	653	692	1,916	2,524
PBT bef. Extra-ordinary	1,835	2,027	2,223	2,309	2,721	3,099	3,104	3,249	8,386	12,173
Provision for Tax	169	203	277	-23	219	206	310	341	632	1,077
Rate (%)	9.2	10.0	12.5	-1.0	8.0	6.6	10.0	10.5	7.5	8.8
Share of Income from Equity Investees	0	-7	-6	7	4	-7	-8	-9	-6	-20
Minority Interest	-9	6	11	8	5	23	25	28	16	81
PAT bef. Extra-ordinary & ESOP chrg	1,675	1,811	1,929	2,331	2,501	2,863	2,760	2,871	7,732	10,995
Q-o-Q Change (%)	3.4	8.1	6.5	20.8	7.3	14.5	-3.6	4.0	27.0	42.2

E: MOST Estimates

2QFY07 operational results in line, other income drives higher PAT growth

HCL Tech reported revenue of Rs14.7b, up 6.2% QoQ (v/s expected 6.6%) backed by growth of 5.2% in software services, 12.5% in infrastructure services and 5.4% in BPO. Software services reported volume growth of 7.1% QoQ (v/s expected 7.8%), while blended price realization was higher than expectation with improvement of around 2% (expected 1%).

Margins improved 45bp during the quarter (v/s expectation of 20bp improvement) despite negative impact of rupee (impact of 150bp) and increase in SG&A (impact of 90bp), primarily due to increase in price realization (impact of 140bp) and improvement in utilization rates (impact of 120bp). Management expects stable margins over the next few quarters.

Client transition was strong during the quarter, greater number of clients migrating to higher revenue brackets – the number of customers with more than US\$50m revenues increased to 3 from 2 and clients with more than US\$10m increased to 22 from 18 in the last quarter. Top clients also performed well during the quarter.

TOP CLIENT REVENUES (RS M)

	DEC-05	MAR-06	JUN-06	SEP-06	DEC-06
Top 5 clients	3,026	3,175	3,523	3,959	4,351
% change QoQ		4.9	11.0	12.4	9.9
Top 6-10 clients	959	1,043	1,141	1,310	1,363
% change QoQ		8.8	9.3	14.9	4.0
Top 11-20 clients	1,139	1,178	1,467	1,614	1,831
% change QoQ		3.5	24.5	10.0	13.5

Source: Company/ Motilal Oswal Securities

Among the verticals, BFSI and Life Sciences outperformed the company average growth rates during the quarter at 26.7% and 21.4% QoQ respectively, while Telecom and Hi-tech & Manufacturing remained muted during the quarter. Management expects Telecom and Hi-tech & Manufacturing (that contribute to 16.2% and 29.7% to revenue resp.) to start picking up from 3QFY07 onwards.

Net profit (before ESOP) grew 14.5% QoQ to Rs2.86b (v/s expected growth of 1.7%) due to high other income of Rs481m versus estimate of Rs210m (forex gains of US\$7.8m and treasury gains of US\$3m) and lower effective tax rate (6.6% v/s expected 9%).

Large deals to lead volume growth over the next few quarters

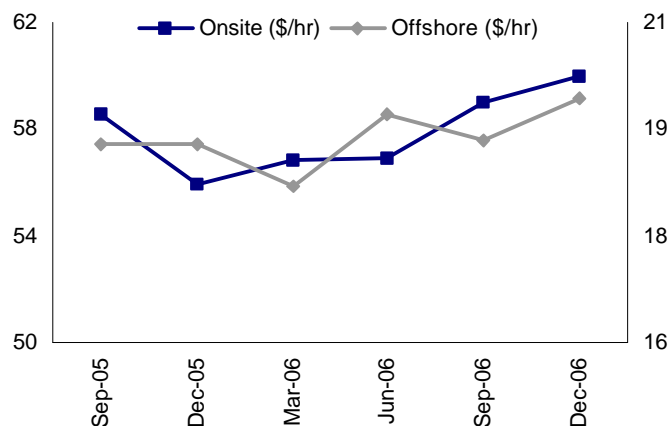
Management is confident of the demand being sustained in CY07 with clients trying to maximize returns from IT investments without large increases in absolute spending. Management therefore expects more total outsourcing deals to come into the market and is confident of bagging deals in this space.

Large deals currently constitute 10% of HCL Tech's total revenue. Of the six large deals won over the last 18 months, two are in a steady state, while the others are either under knowledge transfer or offshore transition phases. With large deals coming off the knowledge transfer phase, margins in large deals could stabilize to company average.

Pricing environment appears to be on a favorable trend

Price realizations improved by around 1.7% onsite and 3.2% offshore during the quarter. HCL Tech is witnessing an increase in pricing to the extent of 3-5% for contract renewals from many of its existing customers at present (compared with minuscule or nil price hikes until the previous quarter). In the case of new contracts, management claims to be witnessing increases as high as 10% at present. The trend towards pricing appears favorable. This is likely to lead to further improvement in realized rates ahead. We expect improvement in realizations to serve as a significant margin positive over the coming years.

PRICE REALIZATIONS ON AN UPWARD TREND



Source: Company/ Motilal Oswal Securities

High attrition likely to keep wage inflation above industry levels

Attrition rates have increased in all segments of the business; voluntary attrition increased to 17.8% from 16.5% in IT services, to 16.8% from 13.1% in Infrastructure services and to 19.9% from 18.5% in BPO. The attrition is highest amongst employees with less than six months experience in the company. We believe that the high attrition rates would compel the company to offer more attractive wage structures to employees, as well as result in greater number of employees being included in its stock option plan. The company is planning to offer higher monthly take home to its employees. This is achieved through a higher fixed component and lower variable component that would increase the per month take-home salary per employee. This in turn is likely to lead to higher fixed wage costs, which could pressurize margins.

HCL Tech currently has 1,250 of its key personnel covered under the ESOP scheme wherein options are granted at less than market price and plans to include more employees over the next few quarters. ESOP charges stood at US\$6m in 2QFY07 (estimate US\$4.4m) and are expected to average US\$6.4m over next few quarters. However, any such fresh ESOPs issued to employees would result in increase in charges to the P&L going forward. We believe cost pressures due to high attrition and ESOP charges could negate the likely improvement in margins due to billing rate increase and SG&A leverage in coming years.

The company added 1,865 employees (net) during the quarter, including 580 in software services, 216 in infrastructure services and 1,069 in BPO. However, the employee addition in software services is lower at 2.6% of last quarter reported employee base; we expect higher lateral additions over the next quarter to make up for volume growth.

Outlook

Given the improved outlook in both revenue, margins and higher other income for 3QFY07 and lower tax rates, we have upgraded our EPS (after ESOP) estimates by 4.4%, 2.2% and 2.1% to Rs30.3, Rs36.5 and Rs44 for FY07E, FY08E and FY09E respectively. The stock is trading at 17.5x FY08E and 14.5x FY09E EPS estimates (after ESOP). 2QFY07 results have increased visibility in terms of revenue growth and margins over the next few quarters; we would like to see greater consistency in revenue and margins in the coming quarters to warrant any significant re-rating. We maintain **Neutral**.

HCL Technologies: an investment profile

Company description

HCL Technologies is the fifth largest IT services company (according to Nasscom's ranking) in India, employing over 38,000 people with a wide portfolio of service offerings including applications, technology, infrastructure and BPO. It generates around US\$200m from technology development services, making it the only other scale player after Wipro in India in that segment. Its key clients include Cisco, KLA Tencor, G-Tech, Deutsche Group and Jones Apparel.

Key investment arguments

- ✍ One of biggest beneficiaries of R&D services outsourcing to India.
- ✍ The most comprehensive IT services company with a wide portfolio of services including R&D, Enterprise, BPO and Infrastructure Management.
- ✍ Experience of integrating successfully and realizing the benefits from acquisitions.

Key investment risks

- ✍ Weaker Enterprise Solutions practice relative to peers.
- ✍ Nearly absent in Application Maintenance Services.

Recent developments

- ✍ Signed a 5-year, US\$200m deal with Skandia, UK to enable migration to a Service Oriented Architecture in order to making Skandia' IT business more cost effective.
- ✍ IDC has rated HCL as a "disruptive force" capable of leading the future of IT services industry.

Valuation and view

- ✍ Revenue CAGR of 34.7% and earnings CAGR of 31.8% over FY06- FY08E.
- ✍ Valuations at 21.1x FY07E and 17.5x FY08E earnings (post ESOP charges) does not offer significant room for upside in near term.
- ✍ Maintain **Neutral**.

Sector view

- ✍ Various CIO surveys indicate increasing share of offshore spending in IT budgets.
- ✍ Indian offshore vendors gaining share versus MNCs.
- ✍ Prefer large companies as the bulk of volumes has been going to them; niche players benefit due to lack of offshore competition.

COMPARATIVE VALUATIONS

		HCLT	SATYAM	PATNI
P/E (x)	FY07E	21.1	24.2	16.6
	FY08E	17.5	20.0	13.3
P/BV (x)	FY07E	4.7	6.1	2.4
	FY08E	4.2	4.9	2.1
EV/Sales (x)	FY07E	3.1	4.5	1.7
	FY08E	2.3	3.3	1.2
EV/EBITDA (x)	FY07E	13.8	19.4	9.1
	FY08E	10.5	14.8	6.8

SHAREHOLDING PATTERN (%)

	DEC.06	SEP.06	DEC.05
Promoters	69.0	69.1	69.7
Domestic Institutions	9.9	11.1	6.3
FII's/FDI's	14.3	14.4	17.5
Others	6.8	5.3	6.5

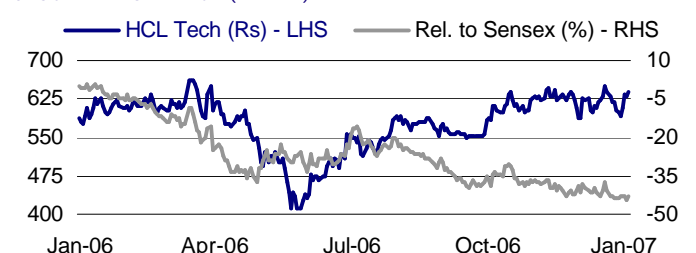
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	33.4	31.6	5.8
FY08	39.5	38.0	4.0

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
639	-	-	Neutral

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT						(Rs Million)					
Y/E JUNE	2005	2006	2007E	2008E	2009E						
Sales	33,627	43,882	60,359	79,602	101,451						
Change (%)	30.9	30.5	37.5	319	27.4						
Cost of Goods Sold	21,168	27,571	37,608	50,806	66,242						
Gross Profit	12,459	16,311	22,750	28,795	35,209						
% of Net Sales	37.1	37.2	37.7	36.2	34.7						
Selling Expenses	4,815	6,582	9,274	11,560	14,150						
% of Net Sales	14.3	15.0	15.4	14.5	13.9						
EBITDA	7,644	9,729	13,476	17,236	21,059						
% of Net Sales	22.7	22.2	22.3	21.7	20.8						
Depreciation	1,482	1,916	2,524	3,332	4,137						
EBIT	6,162	7,813	10,952	13,903	16,922						
% of Net Sales	18.3	17.8	18.1	17.5	16.7						
Other Income	1,062	573	1,221	1,100	1,293						
PBT	7,224	8,386	12,173	15,003	18,215						
Tax	671	632	1,077	1,542	2,086						
Rate (%)	9.3	7.5	8.8	10.3	11.5						
Net Profit	6,553	7,754	11,096	13,462	16,128						
Share of Income from Eq.	-26	-6	-20	-43	-55						
Minority interest	438	16	81	126	153						
Net Income	6,089	7,732	10,995	13,292	15,921						
% of Net Sales	18.1	17.6	18.2	16.7	15.7						
Change (%)	19.7	27.0	42.2	20.9	19.8						
ESOP Charges		655.5	1,030.6	1,003.0	838.5						
Net Income after ESOP	6,089	7,077	9,964	12,289	15,082						
% of Net Sales	18.1	16.1	16.5	15.4	14.9						
Change (%)		16.2	40.8	23.3	22.7						
Extraordinary Item	4.7	604.7	0.0	0.0	0.0						
Net Income after EO	6,084	6,472	9,964	12,289	15,082						

BALANCE SHEET						(Rs Million)					
Y/E JUNE	2005	2006	2007E	2008E	2009E						
Share Capital	632	647	659	675	689						
Other Reserves	37,239	39,910	44,345	50,342	56,025						
Net Worth	37,871	40,557	45,004	51,017	56,714						
Loans	1,308	83	86	0	0						
Minority Interest	111	107	196	322	475						
Capital Employed	39,290	40,747	45,286	51,339	57,189						
Gross Block	11,949	16,011	20,511	24,511	28,511						
Less : Depreciation	5,353	7,269	9,793	13,126	17,263						
Net Block	6,596	8,742	10,718	11,386	11,249						
CWIP	691	1,199	1,215	1,969	2,292						
Intangibles	8,423	8,394	8,179	8,179	8,179						
Investments	18,469	15,889	19,593	22,593	25,093						
Curr. Assets	12,063	16,221	19,366	25,685	34,671						
Debtors	6,408	9,628	12,200	15,279	19,743						
Cash & Bank Balance	2,304	3,022	1,321	3,515	6,196						
Other Current Assets	3,351	3,571	5,845	6,891	8,732						
Current Liab. & Prov	6,952	9,697	13,785	18,472	24,295						
Creditors	462	741	913	1,268	1,512						
Other liabilities	5,819	7,673	10,408	13,203	16,914						
Provisions	671	1,283	2,464	4,002	5,869						
Net Current Assets	5,111	6,524	5,581	7,213	10,376						
Application of Funds	39,290	40,748	45,286	51,339	57,189						

E: MOST Estimates

RATIOS					
Y/E JUNE	2005	2006	2007E	2008E	2009E
Basic (Rs)					
EPS before ESOP chg	19.2	23.9	33.4	39.5	46.4
EPS after ESOP chg		21.9	30.3	36.5	44.0
Cash EPS	23.9	25.9	37.9	46.4	56.0
Book Value	119.8	125.4	136.7	151.2	164.7
DPS	14.8	16.0	22.7	27.4	33.0
Valuation (x)					
P/E before ESOP chg		26.7	19.1	16.2	13.8
P/E after ESOP chg		29.2	21.1	17.5	14.5
Cash P/E		24.6	16.8	13.8	11.4
EV/EBITDA		19.4	13.8	10.5	8.4
EV/Sales		4.3	3.1	2.3	1.7
Price/Book Value		5.1	4.7	4.2	3.9
Dividend Yield (%)		2.5	3.6	4.3	5.2
Profitability Ratios (%)					
RoE	18.1	19.7	25.7	27.7	29.6
RoCE	20.3	21.0	28.3	31.1	33.6
Turnover Ratios					
Debtors (Days)	70	80	74	70	71
Asset Turnover (x)	2.8	2.7	2.9	3.2	3.6
Leverage Ratio					
Debt/Equity (x)	0.0	0.0	0.0	0.0	0.0

CASH FLOW STATEMENT						(Rs Million)					
Y/E JUNE	2005	2006	2007E	2008E	2009E						
CF from Operations	7,571	9,648	13,519	16,625	20,058						
Cash for Working Capital	11,072	4,509	15,678	12,738	12,707						
Net Operating CF	-3,501	5,139	-2,159	3,886	7,350						
Net Purchase of FA	-9,114	-4,541	-4,301	-4,753	-4,323						
Net Purchase of Invest.	855	2,576	-3,615	-2,874	-2,347						
Net Cash from Inv.	-8,259	-1,965	-7,916	-7,627	-6,670						
Issue of shares	42	15	12	16	14						
Proceeds from LTB/STB	-73	-1,225	3	-86	0						
Dividend Payments	-4,679	-5,175	-7,473	-9,250	-11,353						
Net CF from Finan.	-4,709	-6,386	-7,459	-9,319	-11,339						
Free Cash Flow	-1,153	6,912	4,676	9,354	12,672						
Net Cash Flow	48	718	-1,701	2,194	2,682						
Opening Cash Balance	2,256	2,304	3,022	1,321	3,515						
Closing CashBalance	2,304	3,022	1,321	3,515	6,197						

E: MOST Estimates



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HCL Technologies

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|---|----|
| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | No |
| 3. Broking relationship with company covered | No |
| 4. Investment Banking relationship with company covered | No |

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