3QFY07 Results Update

SECTOR: INFORMATION TECHNOLOGY

HCL Technologies

STOCK INFO.	BLOOMBERG
BSE Sensex: 13,607	HCLT IN
	REUTERS CODE
S&P CNX: 3,985	HCLT.BO

Equity Shares (m)	663.7
52-Week Range	358/181
1,6,12 Rel. Perf. (%)	-8/-6/-22
M.Cap. (Rs b)	199.8
M.Cap. (US$ b)	4.8

17 April 2007

Buy

Previous Recommendation: Buy

Rs302

YEAR END	SALES (RS M)	PAT* (RS M)	EPS* (RS)	EPS GROWTH (%)	P/E* (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
6/07E	60,998	10,989	16.6	51.4	18.2	4.1	27.0	28.8	2.9	12.7
6/08E	81,357	13,027	19.2	15.8	15.7	3.7	26.9	29.3	2.1	9.4
6/09E	104,934	16,156	23.3	21.6	12.9	3.4	29.1	32.1	1.6	7.3

* Before extraordinary and after ESOP charges

- **3QFY07 exceeds expectations – all round strong performance:** Consolidated revenue was up 9.5% in dollar terms (positive surprise). This was driven by 8.1% growth in IT, 8.2% growth in infra services and 18.4% growth in BPO (positive surprise). EBIDTA margin improved 125bp to 23.3% despite rupee appreciation of 1.6% QoQ and higher onsite composition (52.3% vs 51% in 2Q). Besides better operational performance, higher other income of Rs615m led to a 15.9% growth in PAT.
- **Operational metrics robust:** Focus verticals registered good QoQ growth (in dollar terms) during the quarter: BFSI 10.6%, telecom 16.2%, and hi-tech and manufacturing 6.5%. Client mining continued to improve with greater number of clients being moved to higher revenue brackets. Employee addition also remained robust, indicating good volume growth ahead. Attrition numbers also came off their highs across all three business domains.
- **Large deals led by infrastructure to power volume growth ahead:** The business outlook remains robust. Large deals continue to be the focus, with six new deals signed in 3QFY07. We believe HCL Tech's focused approach towards infrastructure space would help it capture significant chunk of ITO deals in the face of increasing competition.
- **Outlook and view:** We remain convinced of HCL Tech's ability to outperform in the large deal space, along with greater client mining and new deal wins. Large deals would continue to improve revenue visibility over the coming quarters; improved management transparency would also help. Considering higher than expected revenue growth, higher EBIDTA margin and improving earnings visibility, we upgrade FY08 and FY09 EPS estimates by 4% each to Rs19.2 and Rs23.3 respectively (PAT upgrade higher at 5%; equity dilution by 2.2% due to ESOP exercise in 3QFY07; stopped issuing new ESOPs till clarity on FBT emerges). On revised estimates, the stock trades at 15.7x FY08E and 12.9x FY09E (after ESOP charges), which is attractive. Maintain **Buy** with a target price of Rs410.

QUARTERLY PERFORMANCE (Rs Million)

Y/E JUNE	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Revenues	**9,709**	**10,542**	**11,220**	**12,538**	**13,794**	**14,651**	**15,771**	**16,782**	**43,882**	**60,998**
Q-o-Q Change (%)	*4.7*	*8.6*	*6.4*	*11.7*	*10.0*	*6.2*	*7.6*	*6.4*	*30.5*	*39.0*
Direct Expenses	6,093	6,564	6,979	7,946	8,709	9,107	9,737	10,322	27,571	37,875
Sales, General & Admin. Expenses	1,458	1,601	1,743	1,777	2,098	2,303	2,366	2,545	6,582	9,312
Operating Profit	**2,158**	**2,377**	**2,498**	**2,815**	**2,987**	**3,241**	**3,668**	**3,914**	**9,729**	**13,810**
Margins (%)	*22.2*	*22.5*	*22.3*	*22.5*	*21.7*	*22.1*	*23.3*	*23.3*	*22.2*	*22.6*
Other Income	124	143	255	56	290	481	615	475	573	1,861
Depreciation	447	493	530	562	556	623	659	716	1,916	2,554
PBT bef. Extra-ordinary	**1,835**	**2,027**	**2,223**	**2,309**	**2,721**	**3,099**	**3,624**	**3,673**	**8,386**	**13,117**
Provision for Tax	169	203	277	-23	219	206	283	294	632	1,002
Rate (%)	*9.2*	*10.0*	*12.5*	*-1.0*	*8.0*	*6.6*	*7.8*	*8.0*	*7.5*	*7.6*
Share of Income from Equity Investees	0	-7	-6	7	4	-7	-3	-3	-6	-9
Minority Interest	-9	6	11	8	5	23	20	21	16	69
PAT bef. Extra-ordinary & ESOP chrg	**1,675**	**1,811**	**1,929**	**2,331**	**2,501**	**2,863**	**3,318**	**3,355**	**7,732**	**12,037**
Q-o-Q Change (%)	*3.4*	*8.1*	*6.5*	*20.8*	*7.3*	*14.5*	*15.9*	*1.1*	*27.0*	*55.7*

E: MOSt Estimates

Sandeep R Shah (srshah@MotilalOswal.com); Tel: +91 22 3982 5405 / Diviya Nagarajan (Dnagarajan@MotilalOswal.com); Tel: +91 22 3982 5428

3QFY07 exceeds expectations – all round strong performance

Consolidated revenue was up 9.5% (positive surprise) at US$362.4m. This was driven by 8.1% growth in IT, 8.2% growth in infra services and 18.4% growth in BPO (positive surprise). EBIDTA margin improved 125bp to 23.3% despite rupee appreciation of 1.6% QoQ and higher onsite composition (52.3% vs 51% in 2Q). Beside better operational performance, higher other income of Rs615m led to a 15.9% growth in PAT.

Consolidated dollar revenue of HCL Tech is up 9.5% vs estimate of 6% growth, driven by 8.1% growth in IT services (expected 5.6%), 8.2% growth in infra services (expected 9.3%) and 18.4% growth in BPO (expected 4.3%). Volume growth of 3.9% QoQ in IT services is lower than expected growth of 5.8%. While volume growth in core IT services was slower during the quarter, average realized rate was up 1.7% versus our expectations of flat rates. Higher onsite revenue contribution at 52.3% (51% in the last quarter; our expectation 50.7%) led to higher growth in IT services. We expect ramp ups in large multi-service deals to result in pick up in volume growth over the next few quarters.

EBIDTA margin improved 125bp to 23.3% (expected 22.5%) versus 22.1% in 2QFY07 despite rupee appreciation of 1.6% QoQ (impacting margins by 56bp) and higher onsite composition (52.3% vs 51% in 2Q). This was due to higher realizations, utilization and SG&A leverage, which offset impact of rupee appreciation and salary hikes in BPO. Within the individual business segments, BPO margins grew a whopping 360bp, powered by improved volume growth, realizations and resulting SG&A leverage and higher utilisation rates, which offset the negative impact of rupee and salary increments during the quarter.

We are surprised positively with BPO revenue growth as well as margin improvement. However, we would like to observe the performance of the BPO division in the coming quarters, which may result in upgrade of our estimates for BPO.

EBIT MARGIN IMPROVEMENT CONTRIBUTORS ACROSS SEGEMENTS (BP)

	CORE IT	INFRASTRUCT.	BPO	CONSOLID.
Utilization	20	-100	160	29
Price Realizations	74		197	75
SG&A/Depreciation	50	120	270	90
Rupee Appreciation	-64		-37	-54
Salary Hikes			-100	-15
Total	**80**	**20**	**490**	**125**

Source: Company/ Motilal Oswal Securities

Other income was higher at Rs615m (forex gain of Rs418m and other income of Rs197m) versus our expectation of Rs400m. Higher investible surplus and increased return rates (7.7% v/s 6.7% in 2QFY07) helped boost treasury income during the quarter.

Besides better operational performance, higher other income also led to 15.9% QoQ growth in PAT (before ESOP charges) v/s our estimate of 2.6% growth.

Operational metrics robust during the quarter

Focus verticals registered strong QoQ growth (in dollar terms) during the quarter: BFSI 10.6%; telecom 16.2%, and hi-tech and manufacturing 6.5%. However, like Infosys and TCS, revenue growth from US has been slow for HCL Tech too (at 3.7%). There was all round growth in the client base with top and non- top clients growing strongly during the quarter.

CLIENT MIX (US$ M)

	JUN-06	SEP-06	DEC-06	MAR-07
Top 5 Clients	77	86	98	106
% Growth QoQ	*7.6*	*12.6*	*14.0*	*7.6*
Top 6-10 Clients	25	29	31	34
% Growth QoQ	*6.0*	*15.1*	*7.9*	*9.4*
Top 11-20 Clients	32	35	41	45
% Growth QoQ	*20.7*	*10.3*	*17.7*	*8.6*
Exc. Top 10 Clients	171	186	202	223
% Growth QoQ	*9.0*	*8.5*	*8.8*	*10.3*

Source: Company/ Motilal Oswal Securities

Client mining also continued to improve with greater number of clients being moved to higher revenue brackets during the quarter. The company also increased the number of multi-service clients to 49 from 45 in 2QFY07. Increase in multi-service clients would be a key metric that would indicate the level of account penetration for the client base (currently most of top 20 clients of HCL Tech are multi-service clients).

IMPROVING CLIENT MINING

	JUN-06	SEP-06	DEC-06	MAR-07
No of US$1m Clients	133	143	145	147
No of US$5m Clients	35	41	46	48
No of Million US$10m Clients	15	18	22	25
No of Million US$20m Clients	6	8	8	10
No of Million US$30m Clients	3	4	4	5
No of Million US$40m Clients	3	3	4	4
No of Million US$50m Clients	2	2	3	3
Multiservice Clients		40	45	49

Source: Company/ Motilal Oswal Securities

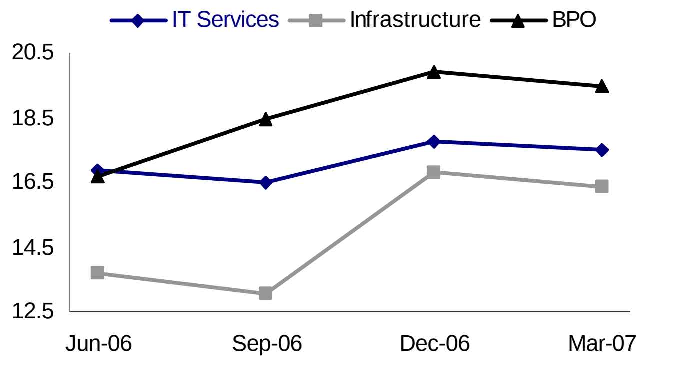
Employee addition also remained robust during the quarter, indicating strong volume growth ahead. Attrition numbers also came off highs across all three business domains.

EMPLOYEE ADDITION

	JUN-06	SEP-06	DEC-06	MAR-07
Total Employees	32,626	36,452	38,317	40,149
Total Gross Addition	5,464	6,795	5,922	5,931
Total Laterals	3,666	3,534	3,084	3,314
Total Net Addition	2,888	3,826	1,865	1,832
Incremental Addition (%)		*11.7*	*5.1*	*4.8*

Source: Company/ Motilal Oswal Securities

ATTRITION OFF PEAK ACROSS ALL BUSINESSES (%)



Source: Company/ Motilal Oswal Securities

Large deals led by infrastructure to power volume growth ahead

Business outlook remains robust for HCL Tech. Large deals continue to be the focus, with six new deals signed during the quarter (with one deal over US$50m, others between US$25-50m, 4 deals in hi-tech space and 2 in BFSI space). In our update on 28 February 2007, we had noted that HCL Tech is the only Indian bidder (other vendors are Accenture, HP, EDS, IBM and ACS) competing for both ITO and BPO deals within the pipeline of TPI. The primary reason for the same is HCL Tech's focused approach towards the infrastructure space, which we believe would help it capture significant chunk of ITO deals in the face of increasing competition. Of the six large deals signed in the last 12 months, some continue to be in the knowledge transfer phase. This could result in further upsides once they move into the revenue generation phase.

No slowdown witnessed in spending as yet

As in the case of Infosys and TCS, HCL Tech is also not witnessing any slowdown in demand due to concerns on the US economy. The management is confident of sustained growth over the next few quarters, with new geographies such as Australia and New Zealand adding to revenue growth (reducing dependence on US).

We remain convinced of HCL Tech's ability to outperform in the large deal space, along with greater client mining and new deal wins. Large deals would continue to improve revenue visibility over the coming quarters; improved management transparency would also serve as a plus.

Outlook and view

Considering higher than expected revenue growth (especially in BPO), higher EBIDTA margin (especially in BPO and IT services) and improving earnings visibility, we upgrade our FY08 and FY09 EPS (after ESOP charges) estimates by 4% each to Rs19.2 and Rs23.3 respectively.

(however PAT upgrade higher at 5%; equity dilution of 2.2% due to ESOP exercise in 3QFY07; HCL Tech has stopped issuing any new ESOPs till clarity on FBT emerges). Currently, 50.6m ESOP are outstanding (down from 65.1m in 2QFY07) which is 7.6% current equity. Based on our assumption and considering fair value of ESOP at our target price of Rs410, we estimate a 5-6% impact on our current EPS due to FBT on ESOP in future (though further clarity awaited in terms of FBT calculations, any pass through of charge to employee, full exercise of ESOP etc). Similarly, any further appreciation of rupee against dollar would also lead to a downside risk to our estimates.

We are impressed with the recent traction in HCL Tech's business owing to expansion of its services portfolio, client mining ability and increasing wins in new business. With critical size in each of its business segments and track record of winning a larger number of large deals, we believe HCL Tech's revenue visibility has improved significantly. On revised estimates, the stock trades at 15.7x FY08E and 12.9x FY09E (after ESOP charges), which is attractive. We maintain **Buy** with a target price of Rs410, a 36% upside.

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 40,000 people with a wide portfolio of service offerings including applications, technology, infrastructure and BPO. It generates over US$200m from technology development services, making it the only other large 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

- Opened a Development Center in Chennai, for Smiths Aerospace, part of the global technology major Smiths Group.
- Opened a dedicated vendor offshore center/facility (VOF) for Microsoft to provide services to global customers on new Microsoft technologies.

Valuation and view

- Revenue CAGR of 31.2% and PAT CAGR of 21.3% over FY07E- FY09E.
- Valuations at 15.7x FY08E and 12.9x FY09E earnings (post ESOP charges) are attractive.
- Maintain **Buy.**

Sector view

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

COMPARATIVE VALUATIONS

		HCLT	SATYAM	PATNI
P/E (x)	FY07E	18.2	21.4	14.5
	FY08E	15.7	17.4	12.1
P/BV (x)	FY07E	4.1	5.3	2.3
	FY08E	3.7	4.2	2.0
EV/Sales (x)	FY07E	2.9	3.9	1.5
	FY08E	2.1	2.8	1.2
EV/EBITDA (x)	FY07E	12.7	16.5	7.9
	FY08E	9.4	12.8	6.1

SHAREHOLDING PATTERN (%)

	MAR-07	DEC.06	MAR.06
Promoter	67.6	69.0	69.4
Domestic Inst	6.0	7.5	6.8
Foreign	16.6	16.7	18.4
Others	9.8	6.8	5.4

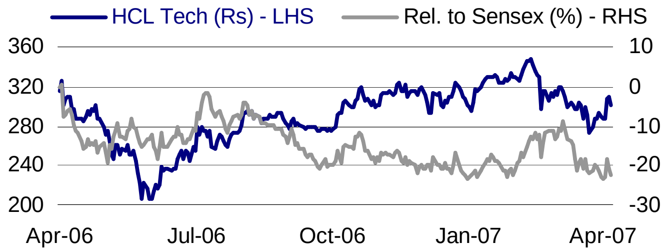
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY08	19.2	19.9	-3.7
FY09	23.3	24.3	-4.2

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
302	410	35.8	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT (Rs Million)

Y/E JUNE	2005	2006	2007E	2008E	2009E
Sales	**33,627**	**43,882**	**60,998**	**81,357**	**104,934**
Change (%)	*30.9*	*30.5*	*39.0*	*33.4*	*29.0*
Cost of Goods Sold	21,168	27,571	37,875	51,190	67,739
Gross Profit	**12,459**	**16,311**	**23,122**	**30,166**	**37,195**
Selling Expenses	4,815	6,582	9,312	12,266	14,793
EBITDA	**7,644**	**9,729**	**13,810**	**17,900**	**22,402**
% of Net Sales	*22.7*	*22.2*	*22.6*	*22.0*	*21.3*
Depreciation	1,482	1,916	2,554	3,413	4,360
EBIT	**6,162**	**7,813**	**11,256**	**14,487**	**18,042**
% of Net Sales	*18.3*	*17.8*	*18.5*	*17.8*	*17.2*
Other Income	1,062	573	1,861	1,300	1,401
PBT	**7,224**	**8,386**	**13,117**	**15,787**	**19,443**
Tax	671	632	1,002	1,621	2,227
Rate (%)	*9.3*	*7.5*	*7.6*	*10.3*	*11.5*
Net Profit	**6,553**	**7,754**	**12,115**	**14,166**	**17,216**
Share of Income from Eq.	-26	-6	-9	-16	-20
Minority interest	438	16	69	95	116
Net Income	**6,089**	**7,732**	**12,037**	**14,055**	**17,080**
% of Net Sales	*18.1*	*17.6*	*19.7*	*17.3*	*16.3*
Change (%)	*19.7*	*27.0*	*55.7*	*16.8*	*21.5*
ESOP Charges		655.5	1,048.2	1,027.8	924.0
Net Income after ESOP	**6,089**	**7,077**	**10,989**	**13,027**	**16,156**
% of Net Sales	*18.1*	*16.1*	*18.0*	*16.0*	*15.4*
Change (%)		*16.2*	*55.3*	*18.5*	*24.0*
Extraordinary Item	4.7	604.7	0.0	0.0	0.0
Net Income after EO	**6,084**	**6,472**	**10,989**	**13,027**	**16,156**

BALANCE SHEET (Rs Million)

Y/E JUNE	2005	2006	2007E	2008E	2009E
Share Capital	632	647	1,327	1,361	1,388
Other Reserves	37,239	39,910	47,438	54,243	60,590
Net Worth	**37,871**	**40,557**	**48,766**	**55,603**	**61,978**
Loans	1,308	83	75	50	25
Minority Interest	111	107	1,511	1,606	1,722
Capital Employed	**39,290**	**40,747**	**50,352**	**57,259**	**63,724**
Gross Block	11,949	16,011	20,511	24,761	29,761
Less : Depreciation	5,353	7,269	9,823	13,236	17,596
Net Block	**6,596**	**8,742**	**10,688**	**11,525**	**12,165**
CWIP	691	1,199	1,241	2,013	2,394
Intangibles	8,423	8,394	8,103	8,103	8,103
Investments	18,469	15,889	19,599	22,599	25,099
Curr. Assets	**12,063**	**16,221**	**23,225**	**32,258**	**39,918**
Debtors	6,408	9,628	12,431	15,653	20,570
Cash & Bank Balance	2,304	3,022	4,849	9,532	10,260
Other Current Assets	3,351	3,571	5,945	7,072	9,087
Current Liab. & Prov	**6,952**	**9,697**	**12,504**	**19,239**	**23,954**
Creditors	462	741	931	1,298	1,577
Other liabilites	5,819	7,673	9,018	12,978	14,255
Provisions	671	1,283	2,556	4,963	8,123
Net Current Assets	**5,111**	**6,524**	**10,721**	**13,019**	**15,964**
Application of Funds	**39,290**	**40,748**	**50,352**	**57,259**	**63,724**

E: MOSt Estimates

RATIOS

Y/E JUNE	2005	2006	2007E	2008E	2009E
Basic (Rs)					
EPS before ESOP chg	**9.6**	**12.0**	**18.1**	**20.7**	**24.6**
EPS after ESOP chg	**9.6**	**10.9**	**16.6**	**19.2**	**23.3**
Cash EPS	12.0	13.0	20.4	24.2	29.6
Book Value	59.9	62.7	73.5	81.7	89.3
DPS	7.4	8.0	12.4	14.1	17.1
Valuation (x)					
P/E before ESOP chg		25.2	16.6	14.6	12.2
P/E after ESOP chg		27.5	18.2	15.7	12.9
Cash P/E		23.2	14.8	12.4	10.2
EV/EBITDA		18.6	12.7	9.4	7.3
EV/Sales		4.1	2.9	2.1	1.6
Price/Book Value		4.8	4.1	3.7	3.4
Dividend Yield (%)		2.7	4.1	4.7	5.7
Profitability Ratios (%)					
RoE	18.1	19.7	27.0	26.9	29.1
RoCE	20.3	21.0	28.8	29.3	32.1
Turnover Ratios					
Debtors (Days)	70	80	74	70	72
Asset Turnover (x)	2.8	2.7	3.0	3.3	3.5
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	14,591	16,681	20,508
Cash for Working Capital	11,072	4,509	11,752	10,346	15,658
Net Operating CF	**-3,501**	**5,139**	**2,839**	**6,335**	**4,849**
Net Purchase of FA	-9,114	-4,541	-4,251	-5,022	-5,380
Net Purchase of Invest.	855	2,576	-2,306	-2,905	-2,384
Net Cash from Inv.	**-8,259**	**-1,965**	**-6,557**	**-7,927**	**-7,765**
Issue of shares	42	15	681	33	27
Proceeds from LTB/STB	-73	-1,225	-8	-25	-25
Dividend Payments	-4,679	-5,175	-8,242	-9,587	-11,890
Net CF from Finan.	**-4,709**	**-6,386**	**-7,569**	**-9,578**	**-11,887**
Free Cash Flow	-1,153	6,912	4,180	10,965	10,330
Net Cash Flow	**48**	**718**	**1,827**	**4,684**	**727**
Opening Cash Balance	**2,256**	**2,304**	**3,022**	**4,849**	**9,533**
Closing CashBalance	**2,304**	**3,022**	**4,849**	**9,533**	**10,260**

E: MOSt Estimates

N O T E S

For more copies or other information, contact
Institutional: Navin Agarwal. **Retail:** Manish Shah
Phone: (91-22) 39825500 Fax: (91-22) 22885038. E-mail: inquire@motilaloswal.com

Motilal Oswal Securities Ltd, 3rd Floor, Hoechst House, Nariman Point, Mumbai 400 021

MOSt and/or its affiliates and/or employees may have interests/ positions, financial or otherwise in the securities mentioned in this report. To enhance transparency, MOSt has incorporated a Disclosure of Interest Statement in this document. This should, however, not be treated as endorsement of the views expressed in the report.

Disclosure of Interest Statement	HCL Technologies
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

This information is subject to change without any prior notice. MOSt reserves the right to make modifications and alternations to this statement as may be required from time to time. Nevertheless, MOSt is committed to providing independent and transparent recommendations to its clients, and would be happy to provide information in response to specific client queries.