ASK | RJ
INDIA EQUITY RESEARCH

18 April 2007

HCL Technologies

Result Update **Rs302; Buy**

Sector: IT

Target Price	**Rs358**
Market cap (bn)	Rs207.3/US$4.9
52-week range	Rs358/181
Shares in issue (mn)	686.8
6-mon avg daily vol (no of shares)	1,521,458
6-mon avg daily vol (mn)	Rs459.3/US$10.9
Bloomberg	HCLT IN
Reuters	HCLT.BO
BSE Sensex	13607
Website	www.hcltechnologies.com

Shareholding Pattern (%)

Promoters	67.6
FIIs	13.6
MFs/FIs/Banks	8.3
Others	10.6

(As of 31 March 2007)

Price Performance (%)

	1M	3M	12M
Absolute	1.0	(6.5)	(4.5)
Relative*	(8.4)	(2.8)	(22.4)

**To the BSE Sensex*

Relative Performance

(As of 17 April 2007)

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Good show

HCL Tech declared 3Q FY07 results better than our expectations. Revenues came in at Rs15.8 bn (+7.6% QoQ; our expectation of Rs15.7 bn) while profits surged by 15.9% sequentially to Rs3.3 bn (our expectation was at Rs3.0 bn). Profit numbers have been higher mainly due to higher than expected other income component (Rs615 mn as against our expectation of Rs400 mn). The management stated that they are not seeing any slowdown in the near term and are making every effort to diversify their revenue base to mitigate risk.

In view of the better than expected results, we have revised our FY07E (June end) EPS to Rs17.1 (+2.5%) and FY08E EPS to Rs19.9 (+1.5%). In-line with the recent downgrades that we had for the exit multiple for the top tier companies, we are reducing the target PE multiple for HCL Tech from 19x to 18x. As a consequence of the above two factors, we are revising our one-year target price downwards to Rs358 (18x FY08E earnings) from Rs370 (19x FY08E earnings). However, we believe that valuations look compelling at the current market price and maintain our Buy recommendation on the stock.

Highlights

- **Good volume growth across segments:** Revenue growth was driven by a good volume growth across segments (+3.9% QoQ in core software; +7.3% in infrastructure; +7.0% in BPO). In addition to this, higher realization, improved utilisation (mainly in the BPO space which saw a 4% improvement) and pay off from risk reward initiatives took the revenues onto a higher growth trajectory.
- **BPO leads growth with a 16.4% QoQ jump:** Core software registered a 6.4% sequential growth to Rs11.4 bn during the quarter. The management mentioned that their focus on micro verticals is seeing good response. Infrastructure space revenues were at Rs2.2 bn (+6.5% QoQ). The outlook for this space remains strong with most of the large deals being led by infrastructure and enterprises applications services. BPO revenues surged during the quarter to Rs2.2 bn (+16.4% QoQ) as a large chunk of employees recruited during 1H FY07 (+2,838 on a net

Exhibit 1: Key financials **(Rs mn)**

Y/E June	2004	2005	2006	2007E	2008E
Net Sales	26,129	33,627	43,975	60,861	77,903
EBITDA	5,424	7,696	9,848	13,633	17,216
EBITDA (%)	20.8	22.9	22.4	22.4	22.1
Net Profit	5,098	6,089	7,682	11,739	13,900
FD EPS (Rs)	8.7	10.2	12.3	17.1	19.9
EPS Growth (%)	53.9	17.0	20.4	38.9	16.2
ROCE (%)	13.0	14.8	16.2	18.5	18.9
ROE (%)	18.9	18.1	19.6	23.4	21.9
PE (x)	34.5	29.5	24.5	17.6	15.2
Price/Book Value (x)	6.1	4.8	4.2	3.5	3.2
EV/EBITDA (x)	35.4	24.7	19.2	12.8	9.9

Source: Company, ASK Raymond James. Note: Valuations as of 17 April 2007.

basis) came out of the training camp to become billable. The management mentioned that the build up was in anticipation of some big projects in the BPO area, as the hiring had to be a step ahead of anticipated revenue growth.

- **US witnesses a flattish growth:** Enterprise application services (+11.9% QoQ), BPO services (+16.4% QoQ), telecom (+14.3% QoQ) and life sciences (+21.1% QoQ), though on a smaller base, were the front runners during the quarter. Region wise, Europe has grown well (+11.3% QoQ) while US was more on the flatter side. A key point to be noted here is that the top two players who have declared their results have also reported similar numbers for the US geography, which remains a concern in our view.

- **Margins increase by 114 bps due to higher utilization and price realization:** Margins increased by 114 bps to 23.3% mainly due to higher utilization and improved price realization. This was offset to a certain extent by rupee appreciation (-54 bps) and an increment given to BPO employees during the quarter. We believe that the company has put up a good show by making optimum use of the available margin levers. PAT margin is significantly higher at 21.0% (19.5% in 2Q FY07) mainly due to significant other income component. The company has increased its forex cover significantly to US$900 mn as on 31 March 2007 vis-à-vis US$516 mn as on 31 December 2006.

- **Multi-services strategy scoring well:** Multi-service clients increased from 45 in 2Q FY07 to 49 in 3Q FY07, which is in-line with the company's strategy of selling a bunch of services to clients. This, in turn, reduces the cost and lead-time in closing the deal and also fetches better rates given the clients prior positive experience.

- **Maintain Buy with revised price target of Rs358:** In view of the better than expected results, we have revised our FY07E (June end) EPS to Rs17.1 (+2.5%) and FY08E EPS to Rs19.9 (+1.5%). In-line with the recent downgrades that we had for the exit multiple for the top tier companies, we are reducing the target PE multiple for HCL Tech from 19x to 18x. As a consequence of the above two factors, we are revising our one-year target price downwards to Rs358 (18x FY08E earnings) from Rs370 (19x FY08E earnings). However, we believe that valuations look compelling at the current market price and maintain our Buy recommendation on the stock.

Exhibit 2: Quarter results (Rs mn)

Y/E June	3Q FY07	2Q FY07	QoQ (%)	3Q FY06	YoY (%)
Revenue	**15,771**	**14,651**	**7.6**	**11,220**	**40.6**
Direct Costs	9,737	9,107	6.9	6,979	39.5
Gross Profit	**6,034**	**5,544**	**8.8**	**4,241**	**42.3**
Revenue (%)	38.3	37.8	0.4	37.8	0.5
SG&A	2,366	2,303	2.7	1,743	35.7
Total Expenses	12,103	11,410	6.1	8,722	38.8
EBITDA	**3,668**	**3,241**	**13.2**	**2,498**	**46.8**
Revenue (%)	23.3	22.1	1.1	22.3	1.0
Depreciation	659	623	5.8	530	24.3
EBIT	**3,009**	**2,618**	**14.9**	**1,968**	**52.9**
Revenue (%)	19.1	17.9	1.2	17.5	1.5
Other Income	615	481	27.9	255	141.2
PBT	**3,624**	**3,099**	**16.9**	**2,223**	**63.0**
Tax	283	206	37.4	277	2.2
PAT	**3,341**	**2,893**	**15.5**	**1,946**	**71.7**
Share of Profit/Loss of Subsidiary	(3)	(7)	(57.1)	(6)	-
Minority Interest	(20)	(23)	(13.0)	(11)	81.8
PAT (Adjusted)	**3,318**	**2,863**	**15.9**	**1,929**	**72.0**
No of shares (mn)	687	683	0.5	678	1.3
EPS (Rs)	**4.8**	**4.2**	**15.3**	**2.8**	**69.8**

Source: Company data.

Exhibit 3: Key operating metrics

	3Q FY06	4Q FY06	1Q FY07	2Q FY07	3Q FY07
Services split (Revenues %)					
Enterprise application services	13	13	14	13	13
Engineering R&D services	24	24	24	24	23
Custom application services	38	38	36	36	36
Infrastructure services	12	13	13	14	14
BPO services	14	13	13	13	14
Geographic split (Revenues %)					
US	59	58	60	57	54
Europe	26	29	29	29	30
Asia Pacific	15	13	12	14	16
Vertical split (Revenues %)					
BFSI	24	-	23	27	28
Hi-Tech Mfg	33	-	31	30	29
Telecom	19	-	17	16	17
Retail	8	-	12	11	9
Media Publishing & Entertainment	6	-	6	6	6
Life sciences	3	-	4	4	5
Others	7	-	8	6	7
Contract type (Revenues %)					
T&M	65	-	71	71	72
Fixed price	35	-	29	29	28
Client metrics					
US$ 1 mn clients (Nos.)	131	133	143	145	147
Top 5 clients concentration (%)	28	28	29	30	29
Top 10 clients concentration (%)	38	37	38	39	39
Active clients (Nos.)	219	-	219	230	236
Number of clients added (Nos.)	24	-	24	23	26
Manpower (Nos.)	**29,948**	**-**	**36,452**	**38,317**	**40,149**

Source: Company data.

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