kotak® Institutional Equities

HCL TECHNOLOGIES

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HCL Technologies: Another round of hedge unwinding in the June quarter

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Technology

HCLT.BO, Rs142	
Rating	REDUCE
Sector coverage view	Neutral
Target Price (Rs)	110
52W High -Low (Rs)	325 - 87
Market Cap (Rs bn)	98.6

Financials

June y/e	2009	2010E	2011E
Sales (Rs bn)	105	115	120
Net Profit (Rs bn)	12.1	9.7	12.2
EPS (Rs)	16.2	12.5	16.7
EPS gth	*5.8*	*(22.6)*	*33.4*
P/E (x)	8.8	11.3	8.5
EV/EBITDA (x)	5.0	4.8	4.6
Div yield (%)	8.5	8.5	8.5

Pricing performance

Perf-1m	Perf-3m	Perf-6m	Perf-1y
7.7	24.5	(5.6)	(53.2)

Shareholding, March 2009

	Pattern	% of Portfolio	Over/(under) weight
Promoters	68.2	-	-
FIIs	16.7	0.3	0.0
MFs	2.4	0.2	(0.1)
UTI	-	-	(0.3)
LIC	2.5	0.1	(0.1)

- **Indicates unwinding of US$600 mn of forward contracts in the June 2009 quarter**
- **No P&L impact of the unwinding, as per the company; we would seek more clarity**
- **Indicates modest improvement in business; not enough to warrant a change in estimates or rating**

HCL Technologies (HCLT) has indicated that it is unwinding US$600 mn of its USD/INR forward contracts in the June 2009 quarter. These hedges pertain to the Sep 2009 and Dec 2009 quarters. The company indicates that the US$ debt of roughly a similar amount would act as a natural hedge to net US$ inflows. The company also indicates a sharp shift in its hedging policy—HCLT would now hedge its net cash inflows for a quarter as opposed to the policy of 8-10 quarters followed earlier. We find the 'Axon debt natural hedge' argument a bit surprising given that the bridge loan taken to finance the Axon acquisition matures in December and the company indicates that it is likely to refinance the same with a long-term Re denominated loan. In addition, this marks another episode of the company's hedging-related opportunism. The company has also indicated that the accounting impact of this unwinding will be minimal in the June 2009 quarter; however, we would seek clarification for the same—we highlight that HCLT had taken a cash charge of US$9 mn in the June 2008 quarter when it had cancelled US$540 mn of contracts. The company indicates some improvement in the business fundamentals, the important one being US$60 mn worth cross-selling business won with three Axon clients. However, we continue to remain concerned about the company's organic revenue growth engine and the profitability profile of recent large deals. Maintain REDUCE.

Indicates unwinding of US$600 mn of forward contracts in the June 2009 quarter. HCLT has indicated that it will unwind US$600 mn of its underlying USD/INR forward contracts pertaining to the Sep 2009 and Dec 2009 quarters. The company's outstanding hedges are likely to reduce to US$700 mn post this unwinding. The company has indicated the following reasons for the decision to unwind hedges:

- Natural hedge available in the form of US$ debt raised for Axon acquisition. HCLT had taken a bridge loan of ~US$700 mn to finance the acquisition of UK-based Axon recently. The loan is due for repayment in the December 2009 quarter. The debt acts as a natural hedge to the approximate US$300 mn per quarter of net US$ cash inflows for the company. The company also indicated that it would refinance this bridge loan with a long-term Re-denominated loan.
- Change in hedging philosophy. HCLT indicates a change in its hedging philosophy to hedging one quarter of net cash inflows from the 8-10 quarters indicated earlier. We have long highlighted HCLT's hedging policy as inconsistent (and a bit opportunistic) and this event lends further credence to the lack of a well-thought, long-term hedging policy.

No P&L impact of the unwinding, as per the company; we would seek more clarity. In its 2QFY09 earnings call, HCLT had indicated forex losses (on cash-flow hedges) of US$32 mn, US$35 mn, and US$37 mn for the Jun 2009, Sep 2009, and Dec 2009 quarters respectively. The company indicates that the unwinding of forex covers will have no impact on the quarter-wise forex losses indicated. We would seek more clarity on the same.

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Indicates modest improvement in business; not enough to warrant a change in estimates or rating. The company indicated some signs of improvement in the demand fundamentals, especially pertaining to Axon-related revenue synergies. The company has signed contracts worth US$60 mn with three of the top five Axon clients. However, organic revenue growth continues to be muted with little signs of improvement in the BFSI or Telecom verticals. We continue to remain concerned about the company's organic revenue growth engine and the profitability profile of recent large deals. Maintain REDUCE rating on the stock.

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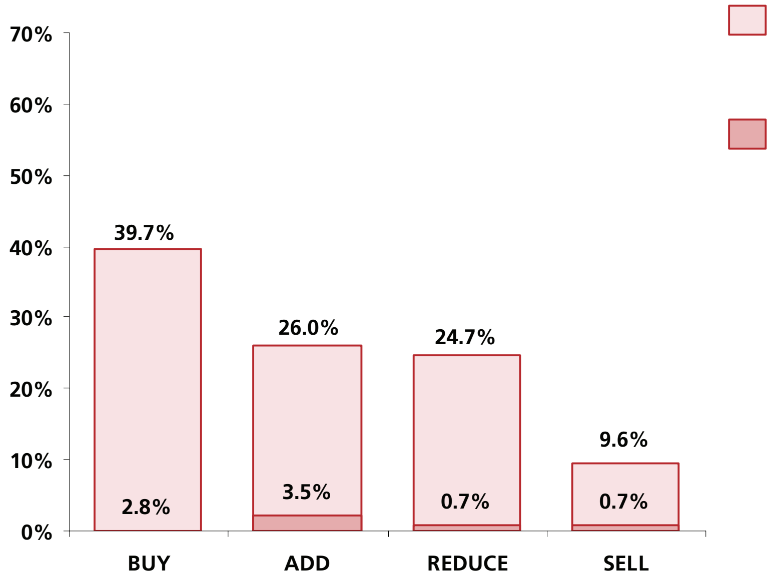

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Source: Kotak Institutional Equities

As of March 31, 2009

Ratings and other definitions/identifiers

Rating system

Definitions of ratings

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ADD. We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.
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SELL: We expect this stock to underperform the BSE Sensexby more than 10% over the next 12 months.

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