

Telecoms, Media & Technology
IT Services
Equity – India

HCL Technologies

Overweight (V)

Target price (INR)	455.00		
Share price (INR)	345.35		
Potential total return (%)	31.8		
Performance	1M	3M	12M
Absolute (%)	-7.7	-6.8	150.0
Relative ^A (%)	-7.1	-9.0	56.0
Index ^A	BOMBAY SE IDX		
RIC	HCLT.BO		
Bloomberg	HCLT IN		
Market cap (USDm)	5,253		
Market cap (INRm)	233,624		
Enterprise value (INRm)	227,699		
Free float (%)	23		

Note: (V) = volatile (please see disclosure appendix)

OW(V): 3Q – Strong broad-based growth

- ▶ **Robust 3Q reinforces our positive outlook on HCL**
- ▶ **Expect growth momentum to continue, led by further offshoring and pick-up in cyclical services**
- ▶ **Remain OW(V) with a TP of INR455**

HCL reported robust 3Q with revenues of USD685 (+5.1% q-o-q), outperforming peers in the sector vs. our expectation of USD669m +2.7% q-o-q. The growth is noteworthy in light of the 1.8% cross currency impact and USD6m loss in the BPO division (c1% of revenues). The quarter witnessed an 11% growth in the R&D services, 5.4% in the ADM services, and 16.3% in the Infra services (IMS). We expect this growth momentum to continue in FY11/12 driven by continued offshoring growth in services such as IMS and pick-up in cyclical services such as ERP services. Further, growth in ADM services would be driven by reinstatement of deals signed early in 2009 and were put on hold by clients due to weaker business outlook. The deal pipeline for HCL remains strong in 3Q and with an improving client profile, the scope of client-mining would help sustain growth as well (refer page 4 for detailed forecasts).

EBIT margins declined by 40bps q-o-q, led by a loss of USD2m in BPO, currency headwinds, and growth in lower margin business in IT Services. We expect margins to decline in 1QFY11, as the company offers a further round of wage increments in July, but overall EBITDA margins in FY11 are expected to remain at 20.7%, a modest decline from FY10.

Valuation discount unwarranted: The stock is trading at c13x FY11e EPS and 10.5x on our FY12e EPS. We value the stock at a TP of INR455, at 15x on our 2011 EPS (a 25% discount to Infosys). We believe, with the improving growth momentum of the company, returns on the stock would be driven by a strong earnings growth and valuation re-rating. HCL is currently trading at a c44% discount to Infosys on FY12e and we expect this discount to shrink to c25% (please refer page 3 for more details).

Risks – Slowdown in the macroeconomic recovery; significant margin pressure due to wage inflation and supply side constraints, and currency fluctuations. Catalysts for the stock include: growing IT spending by clients, and SAP results on 28 April 2010.

22 April 2010

Yogesh Aggarwal *
Analyst
HSBC Securities and Capital Markets
Pvt. Ltd.
+9122 2268 1246
yogeshaggarwal@hsbc.co.in

Atul Agrawal *
Associate
Bangalore

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This report must be read with the disclosures and the analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it

HCL Technologies: Key financial highlights

YE June	Sales (INRm)	EBIT (%)	EPS (INR)	EPS y/y	P/E
FY09a	105,910	17.6%	19.14	8.4%	18.0x
FY10e	122,970	16.8%	18.90	-1.2%	18.3x
FY11e	141,014	17.1%	27.07	43.2%	12.8x

Source: HSBC Estimates, Company data

Financials & valuation

Financial statements

Year to	06/2009a	06/2010e	06/2011e	06/2012e
Profit & loss summary (INRm)				
Revenue	105,910	122,970	141,014	168,640
EBITDA	22,639	25,644	29,188	35,577
Depreciation & amortisation	-4,510	-5,002	-5,020	-6,050
Operating profit/EBIT	18,129	20,643	24,168	29,527
Net interest	1,624	-528	-353	352
PBT	14,852	15,930	23,032	29,879
HSBC PBT	14,852	15,930	23,032	29,879
Taxation	-2,544	-2,912	-4,146	-7,769
Net profit	12,333	12,972	18,708	22,066
HSBC net profit	12,333	12,972	18,708	22,066

Cash flow summary (INRm)

Cash flow from operations	40,050	14,269	22,146	28,342
Capex	-5,329	-7,378	-8,461	-10,118
Cash flow from investment	-34,214	-9,165	-8,461	-10,118
Dividends	-7,222	-3,373	-5,396	-5,396
Change in net debt	35,395	-6,738	-8,415	-12,827
FCF equity	10,227	15,146	14,646	18,268

Balance sheet summary (INRm)

Intangible fixed assets	45,325	44,710	43,312	43,312
Tangible fixed assets	15,862	17,380	20,277	24,345
Current assets	56,777	56,969	68,513	87,698
Cash & others	18,995	20,487	28,135	40,963
Total assets	126,939	129,022	141,754	165,007
Operating liabilities	40,309	40,577	42,764	49,348
Gross debt	29,771	24,526	23,759	23,759
Net debt	10,776	4,038	-4,377	-17,204
Shareholders funds	56,843	63,919	75,231	91,901
Invested capital	58,660	57,994	61,202	65,045

Ratio, growth and per share analysis

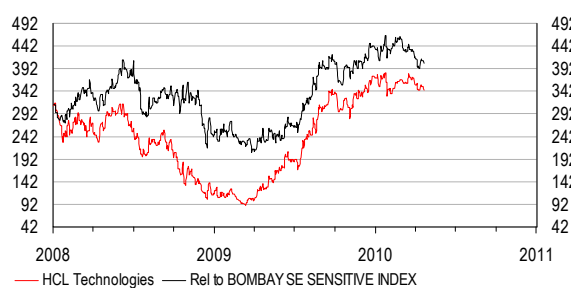
Year to	06/2009a	06/2010e	06/2011e	06/2012e
Y-o-y % change				
Revenue	31.0	16.1	14.7	19.6
EBITDA	26.4	13.3	13.8	21.9
Operating profit	23.3	13.9	17.1	22.2
PBT	10.5	7.3	44.6	29.7
HSBC EPS	8.2	-1.1	43.2	20.9
Ratios (%)				
Revenue/IC (x)	2.6	2.1	2.4	2.7
ROIC	37.0	28.9	33.3	34.6
ROE	22.6	21.5	26.9	26.4
ROA	11.9	10.2	13.9	14.4
EBITDA margin	21.4	20.9	20.7	21.1
Operating profit margin	17.1	16.8	17.1	17.5
EBITDA/net interest (x)		48.6	82.6	
Net debt/equity	19.0	6.3	-5.8	-18.7
Net debt/EBITDA (x)	0.5	0.2	-0.1	-0.5
CF from operations/net debt	371.7	353.3		
Per share data (INR)				
EPS reported (fully diluted)	19.10	18.90	27.07	32.71
HSBC EPS (fully diluted)	19.10	18.90	27.07	32.71
DPS	7.00	5.00	8.00	8.00
Book value	86.45	95.42	112.30	137.19

Valuation data

Year to	06/2009a	06/2010e	06/2011e	06/2012e
EV/sales	2.2	1.9	1.6	1.2
EV/EBITDA	10.4	8.9	7.5	5.8
EV/IC	4.0	3.9	3.6	3.2
PE*	18.1	18.3	12.8	10.6
P/Book value	4.0	3.6	3.1	2.5
FCF yield (%)	4.6	6.8	6.5	8.2
Dividend yield (%)	2.0	1.4	2.3	2.3

Note: * = Based on HSBC EPS (fully diluted)

Price relative

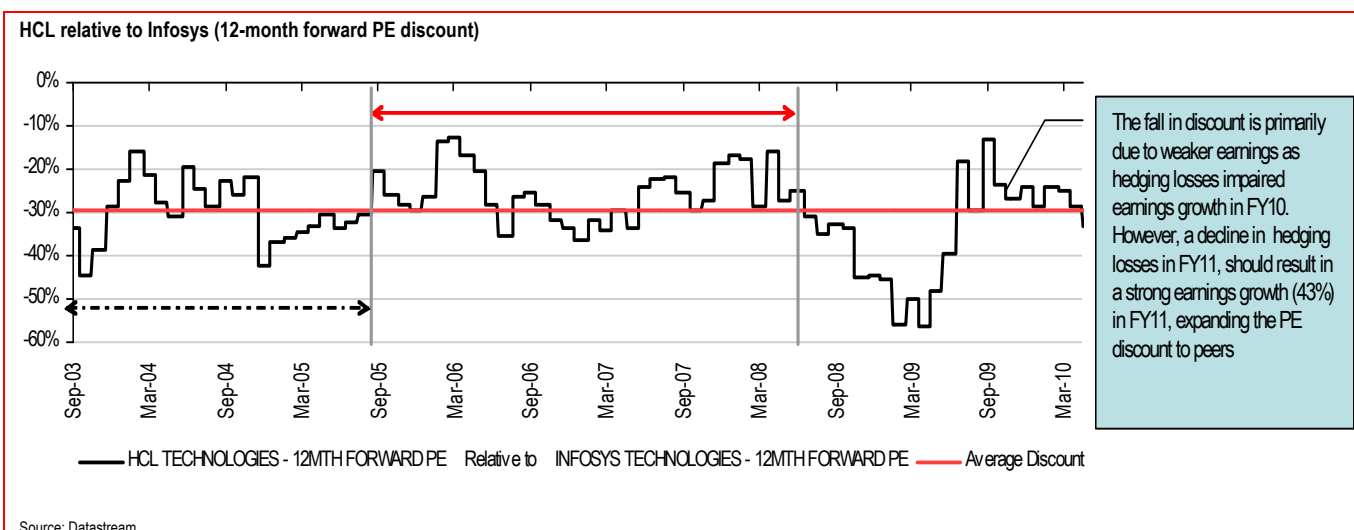
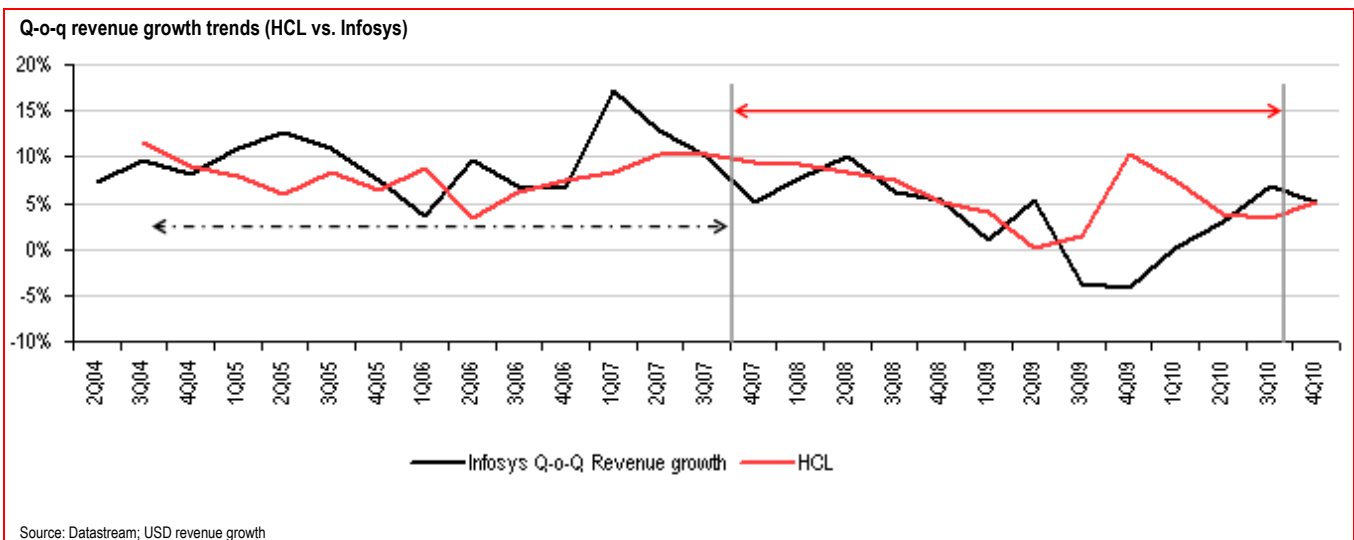


Source: HSBC

Note: price at close of 21 Apr 2010

HCL's historic relative operational performance and valuation discount to Infosys, supports our bullish view on the company

- ▶ HCL outperformed Infosys in terms of q-o-q revenue growth in nine out of the 13 quarters in the period 2Q07 to 2Q10 (please refer the charts at the bottom of the page). Prior to this period, the q-o-q growth for HCL was weaker compared to Infosys (from 2Q04 to 2Q07).
- ▶ In line with this operational outperformance, HCL's PE discount to Infosys was lower in the period of September 2005 to June 2008. Not surprisingly, the discount was higher in the period prior to this outperformance in 2003 and 2004.
- ▶ We therefore expect HCL's discount to Infosys to go down further in 2010 and 2011, as growth remains robust and earnings growth momentum continues.



3QFY10 Results highlights

HCL Technologies reported a strong quarter with revenues of USD685m (up 5.1% q-o-q, up 7% q-o-q in constant-currency terms), against our expectations of USD669m. EBIT margins declined by 40bps q-o-q, led by a loss of USD2m in BPO, currency headwinds and growth in lower margin business in IT Services.

- ▶ **IT Services:** Volumes in the IT Services division grew by c7% q-o-q. Enterprise Application Services (EAS – SAP/Oracle implementation and maintenance) business grew by 2.5% q-o-q in constant currency terms, while Customer Apps (ADM) grew by 2.5% q-o-q. Engineering & R&D services grew by c11% q-o-q. There was a gross headcount addition of 4,639, and net addition of 2,714 during the quarter, resulting in 8% increase in headcount q-o-q.
- ▶ **Infrastructure Management Services:** IMS Services recorded a robust growth of c15% q-o-q and c77% y-o-y. Operating margins improved by c70bps compared to the previous quarter. Gross employee addition was 1,091 and the net addition was 438, resulting in 4% increase in headcount q-o-q.
- ▶ **BPO Services:** BPO underperformed this quarter with revenues decline of 9.2% q-o-q. The company expects the restructuring to continue and revenues to decline further to USD45m from the current USD52m. However, EBITDA losses would remain in the range of USD2-3m and the division is likely to break-even by the end of FY11.
- ▶ **Utilisation** excluding trainees improved by c100bps to 79% and remained flat including trainees to 76.2%.

HCL Technologies: Quarterly segmental growth (as reported)

	1Q08	2Q08	3Q08	4Q08	FY08	1Q09	2Q09	3Q09	4Q09	FY09	1Q10	2Q10	3Q10	Proportion in 3Q10
US	8%	9%	7%	7%	34%	0%	6%	13%	4%	24%	3%	0%	10%	60%
Europe	9%	4%	5%	2%	35%	-1%	-4%	12%	9%	9%	7%	5%	-5%	27%
APAC	6%	10%	0%	-3%	39%	3%	-4%	-4%	21%	2%	0%	14%	7%	14%
Total	8%	7%	5%	4%	35%	0%	1%	10%	7%	16%	4%	3%	5%	100%
Enterprise Application Services	7%	1%	1%	5%	17%	1%	16%	116%	3%	92%	-3%	6%	0%	21%
Engineering and R&D Services	12%	8%	7%	9%	45%	-1%	-1%	-6%	-5%	6%	0%	0%	11%	19%
Custom Application	8%	11%	7%	0%	37%	-1%	-7%	-5%	12%	0%	8%	3%	3%	30%
Infrastructure Services	9%	9%	2%	6%	45%	4%	7%	1%	25%	26%	15%	8%	15%	22%
BPO Services	2%	1%	2%	0%	21%	1%	11%	-11%	4%	6%	0%	-2%	-9%	8%
Total	8%	7%	5%	4%	35%	0%	1%	10%	7%	16%	4%	3%	5%	100%
Financial Services	8%	9%	2%	0%	43%	1%	1%	-5%	13%	6%	10%	3%	3%	26%
Manufacturing	13%	2%	9%	8%	36%	0%	1%	10%	9%	20%	-8%	-3%	10%	27%
Telecom	3%	6%	7%	1%	30%	3%	-3%	-15%	11%	1%	8%	-1%	-2%	12%
Retail	3%	9%	0%	9%	15%	-7%	-5%	-1%	3%	-2%	10%	18%	-1%	8%
Media Publishing & Entertainment	6%	15%	2%	2%	34%	0%	0%	0%	20%	11%	26%	10%	15%	8%
Life Sciences	15%	16%	3%	8%	74%	4%	0%	20%	9%	29%	4%	16%	10%	8%
Others	7%	13%	11%	1%	22%	-7%	34%	136%	-10%	111%	3%	6%	4%	13%
Total	8%	7%	5%	4%	35%	0%	1%	10%	7%	16%	4%	3%	5%	100%

Source: HSBC Estimates, Company data

HCL Technologies: Quarterly P&L

	1QFY10	2QFY10	3QFY10	4QFY10e	1QFY11e	2QFY11e	3QFY11e	4QFY11e	FY10e	FY11e
Total efforts billed (man hours) – IT Services	71,117	72,034	77,216	80,862	83,874	87,838	92,230	97,513	301,229	361,454
Volume growth q-o-q	1%	1%	7%	5%	4%	5%	5%	6%	10%	20%
Revenues (USDm)										
IT Services	449	462	481	500	517	540	569	609	1,892	2,236
Q-o-q Growth	2%	3%	4%	4%	3%	4%	5%	7%	19%	18%
Infrastructure Services	123	132	152	161	171	181	190	199	567	741
Q-o-q Growth	14%	8%	15%	6%	6%	6%	5%	5%	59%	31%
BPO Services	59	58	52	49	46	47	49	51	217	193
Q-o-q Growth	0%	-2%	-10%	-6%	-6%	2%	4%	5%	-8%	-11%
Total revenues	630	652	685	710	734	768	808	859	2,677	3,169
Q-o-q Growth	4%	3%	5%	4%	3%	5%	5%	6%	23%	18%
EBITDA	143	137	135	142	139	158	171	188	558	656
EBITDA Margins	23%	21%	20%	20%	19%	21%	21%	22%	21%	21%
EBIT	114	108	111	117	112	130	142	159	449	543
EBIT Margins	18%	17%	16%	16%	15%	17%	18%	18%	17%	17%
Net Profit	67	64	77	77	79	101	113	127	282	420
Net Profit Margins	11%	10%	11%	11%	11%	13%	14%	15%	11%	13%
EPS	0.10	0.09	0.11	0.11	0.11	0.15	0.16	0.18	0.41	0.61
EPS growth	-5%	-5%	20%	0%	3%	27%	12%	13%	5%	48%

Source: HSBC Estimates, Company data

Valuation

The stock is trading at c13x FY11e EPS and 10.5x our FY12e EPS. We value the stock at a TP of INR455, at 15x on our 2011 EPS (a 25% discount to Infosys). We believe, with the improving growth momentum of the company, returns on the stock would be driven by a strong earnings growth and valuation re-rating. HCL is currently trading at a c44% discount to Infosys on FY12e and we expect this discount to shrink to c25%. Under our research model, for stocks with a volatility indicator, the Neutral band is 10 percentage points above and below the hurdle rate for India stocks of 10.5%. For HCL, this translates into a Neutral band of 0.5-20.5% around the current share price. We have an Overweight (V) rating on the stock.

Risks

Slowdown in the macroeconomic recovery; significant margin pressure due to wage inflation and supply side constraints; currency fluctuations and disappointment on the growth of IT budgets in 2011 and ERP market remains weak longer than expected, SAP losing market share to Oracle.

Disclosure appendix

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For each stock we set a required rate of return calculated from the risk free rate for that stock's domestic, or as appropriate, regional market and the relevant equity risk premium established by our strategy team. The price target for a stock represents the value the analyst expects the stock to reach over our performance horizon. The performance horizon is 12 months. For a stock to be classified as Overweight, the implied return must exceed the required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile*). For a stock to be classified as Underweight, the stock must be expected to underperform its required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile*). Stocks between these bands are classified as Neutral.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

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Prior to this, from 7 June 2005 HSBC applied a ratings structure which ranked the stocks according to their notional target price vs current market price and then categorised (approximately) the top 40% as Overweight, the next 40% as Neutral and the last 20% as Underweight. The performance horizon is 2 years. The notional target price was defined as the mid-point of the analysts' valuation for a stock.

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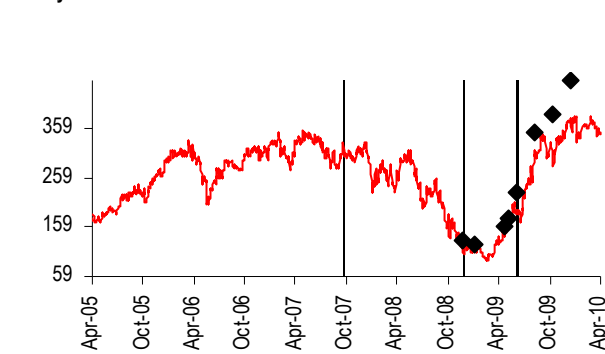
Rating distribution for long-term investment opportunities

As of 21 April 2010, the distribution of all ratings published is as follows:

Overweight (Buy)	48%	(13% of these provided with Investment Banking Services)
Neutral (Hold)	38%	(10% of these provided with Investment Banking Services)
Underweight (Sell)	14%	(10% of these provided with Investment Banking Services)

Share price and rating changes for long-term investment opportunities

HCL Technologies (HCLT.BO) Share Price performance INR Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
Neutral	N/A	04 October 2007
N/A	Neutral (V)	10 December 2008
Neutral (V)	Overweight (V)	24 June 2009
Target Price	Value	Date
Price 1	N/A	04 October 2007
Price 2	130.00	10 December 2008
Price 3	125.00	26 January 2009
Price 4	160.00	12 May 2009
Price 5	175.00	26 May 2009
Price 6	230.00	24 June 2009
Price 7	350.00	25 August 2009
Price 8	385.00	30 October 2009
Price 9	455.00	07 January 2010

Source: HSBC

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
HCL TECHNOLOGIES	HCLT.NS	345.35	21-Apr-2010	4

Source: HSBC

- 1 HSBC* has managed or co-managed a public offering of securities for this company within the past 12 months.
- 2 HSBC expects to receive or intends to seek compensation for investment banking services from this company in the next 3 months.

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- 2 All market data included in this report are dated as at close 21 April 2010, unless otherwise indicated in the report.
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Issuer of report

HSBC Securities and Capital Markets (India) Private Limited

Registered Office

52/60 Mahatma Gandhi Road

Fort, Mumbai 400 001, India

Telephone: +91 22 2267 4921

Fax: +91 22 2263 1983

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