ANANDRATHI

India I Equities

IT Services

Analyst Meet

Change in Estimates ☐ Target ☑ Reco ☐

29 September 2009

HCL Technologies

Key takeaways from analyst meet

Rating: **Buy**
Target Price: 425
Share Price: Rs336

- **Focus on large-deal wins.** Management's states that the outlook for EAS and RIM services is positive, supporting our view that these horizontals would contribute to HCL's growth. Key takeaways: sharper focus on infrastructure, and the company's strategy and ability to win large outsourcing deals.

- **New verticals, technologies.** For new practices, HCL Tech is aggressively taking steps such as expanding sales and marketing teams, and building delivery centres for future technologies, clearly indicating that it is gearing up for the next level of competition.

- **Financial services – handling mature businesses.** HCL Tech provides a total IT outsourcing solution, with greater emphasis on cross-selling. It is increasing its domain expertise to provide greater customer satisfaction. This should result in greater customer loyalty, advocacy, satisfaction and value.

- **Telecoms, Media and Entertainment – handling immature businesses.** HCL Tech is providing focused vertical-based solutions by breaking up these verticals into micro-verticals. It is also investing in new domain-led services and focusing on moving up the value chain to more deeply penetrate the verticals.

- **Valuation.** We re-rate HCL Tech from 15x FY11e earnings to 17x on its sharper focus on clients, technologies and profitability. Hence, we raise our target price to Rs425 (17x FY11e earnings of Rs25). We maintain our Buy rating.

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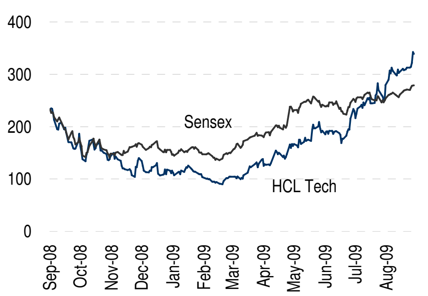
Key data	HCLT IN / HCLT.BO
52-week high/low	Rs351/ Rs89
Sensex/Nifty	16693/4955
3-m average volume	US$10.2m
Market cap	Rs226bn/ US$4.7bn
Shares outstanding	670m
Free float	31.8%
Promoters	68.2%
Foreign Institutions	17.9%
Domestic Institutions	4.9%
Public	9.0%

Key financials

Year end 30 Jun	FY07	FY08	FY09	FY10e	FY11e
Sales (Rsm)	60,337	76,394	106,301	121,348	142,851
Net profit (Rsm)	13,613	11,264	12,749	13,770	16,974
EPS (Rs)	20.4	16.9	19.1	20.4	25.0
Growth (%)	70.5	(17.3)	13.0	7.1	22.5
PE (x)	16.5	19.9	17.6	16.5	13.4
PBV (x)	4.5	4.4	4.3	4.0	3.3
RoE (%)	30.8	22.6	24.0	22.5	22.8
RoCE (%)	32.4	22.8	20.1	18.3	20.1
Dividend yield (%)	2.4	2.7	2.1	1.2	1.2
Net gearing (%)	(45.1)	(39.6)	38.3	27.9	12.0

Source: Bloomberg estimates

Relative price performance



Source: Anand Rathi Research

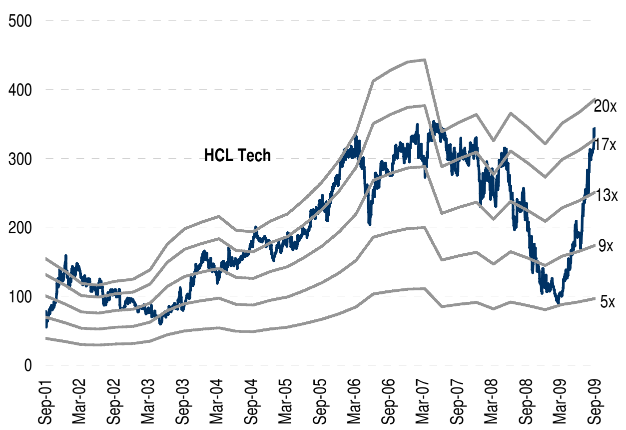
Quick Glance – Financials and Valuations

Fig 1 – Income statement (Rsm)

Year end 30 Jun	FY07	FY08	FY09	FY10e	FY11e
Net sales	60,337	76,394	106,301	121,348	142,851
Sales growth (%)	37.1	26.6	39.1	14.2	17.7
- Op. expenses	46,966	59,455	82,845	93,851	110,933
EBIDTA	13,371	16,939	23,456	27,497	31,918
EBITDA margins (%)	22.2	22.2	22.1	22.7	22.3
- Interest	-	-	-	1,496	1,496
- Depreciation	2,532	3,033	4,493	5,875	7,577
+ Other income	4,259	(1,370)	(3,671)	(3,333)	(1,627)
- Tax	1,485	1,272	2,543	3,023	4,244
PAT	13,613	11,264	12,749	13,770	16,974
PAT growth (%)	75.3	(17.3)	13.2	8.0	23.3
Consolidated PAT	13,549	11,245	12,776	13,770	16,974
FDEPS (Rs/share)	20.4	16.9	19.1	20.4	25.0
CEPS (Rs/share)	24.2	21.4	25.8	29.1	36.2
DPS (Rs/share)	8.0	9.0	7.0	4.0	4.0

Source: Company, Anand Rathi Research

Fig 4 – PE Band



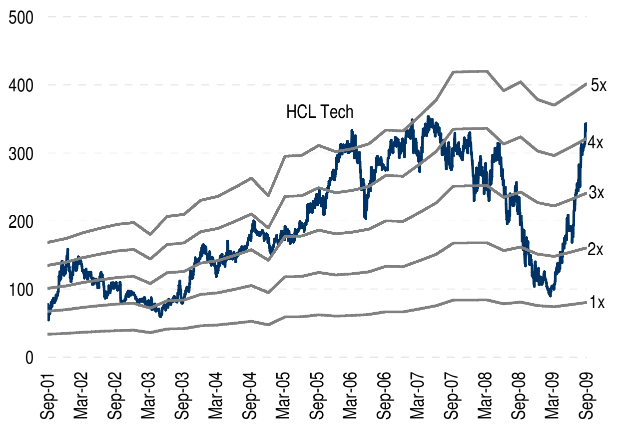
Source: Anand Rathi Research

Fig 2 – Balance sheet (Rsm)

Year end 30 Jun	FY07	FY08	FY09	FY10e	FY11e
Share capital	1,327	1,333	1,341	1,349	1,358
Reserves & surplus	46,478	45,781	46,695	57,583	73,089
Shareholders' fund	47,805	47,114	48,036	58,932	74,446
Debt	1,292	5,959	37,405	37,405	37,405
Minority interests	141	57	16	16	16
Capital employed	49,238	53,130	85,457	96,353	111,867
Fixed assets	10,495	13,317	15,862	23,062	28,062
Investments	27,421	30,465	60,286	60,494	63,494
Working capital	7,735	5,508	5,106	6,818	9,002
Cash	3,587	3,840	4,203	5,979	11,310
Capital deployed	49,238	53,130	85,457	96,353	111,867
No. of shares (m)	663.7	666.3	670.3	674.5	678.8
Net Debt/Equity (%)	(45.1)	(39.6)	38.3	27.9	12.0
W C turn (days)	46.8	26.3	17.5	20.5	23.0

Source: Company, Anand Rathi Research

Fig 5 – Price-to-Book Band



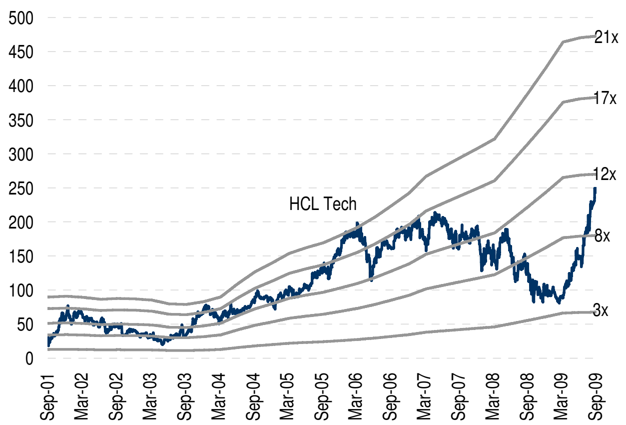
Source: Anand Rathi Research

Fig 3 – Cash flow statement (Rsm)

Year end 30 Jun	FY07	FY08	FY09	FY10e	FY11e
Consolidated PAT	13,549	11,245	12,776	13,770	16,974
+Depreciation	1,193	315	749	5,201	7,577
Cash profit	14,742	11,560	13,525	18,972	24,551
- Incr/(Decr) in WC	3,267	(2,227)	(402)	1,712	2,183
Operating cash flow	11,475	13,787	13,927	17,259	22,368
-Capex	4,285	5,855	7,038	13,075	12,577
Free cash flow	7,190	7,932	6,889	4,185	9,791
-Dividend	6,064	7,002	5,482	3,149	3,177
+ Equity raised	2,140	(2,300)	(2,669)	948	1,717
+ Debt raised	464	4,667	31,446	-	-
-Investments	2,554	3,044	29,821	208	3,000
-Misc. items	-	-	-	-	-
Net cash flow	1,176	253	363	1,776	5,331
+Opening cash	2,411	3,587	3,840	4,203	5,979
Closing cash	3,587	3,840	4,203	5,979	11,310

Source: Company, Anand Rathi Research

Fig 6 - EV/EBITDA



Source: Anand Rathi Research

Analyst meet – Key takeaways

HCL Tech held an Analyst Day at its Noida facility. Senior management and business-unit heads offered insights into the company's various business divisions and growth strategy.

Key takeaways of the analyst meet follow.

Winning large deals in a recessionary environment. Speakers at the session were Harsh Kumar (VP, Strategic Sourcing), Anant Gupta (CEO, HCL's Infrastructure Services) and Sandip Gupta (Corporate VP-Finance).

Harsh Kumar took us through the process which has helped HCL Tech secure more than its fair share of **large IT deals** than its peers. Deals of US$50-250m are a part of large deals. The company offers complete end-to-end solutions to its clients. This includes business process outsourcing, custom application services, engineering and R&D services, enterprise application services, enterprise transformation services and IT infrastructure management. Due to the wide gamut of offerings, HCL Tech not only helps CIOs (of customer companies) cut IT spending but also saves costs by way of business transformation. This includes benefits such as lower profit leaks, inventory turnover and DSOs. The company reduces the process cycle time, thus improving customer experience ("right time first" strategy).

Even in multi-vendor deals, where HCL Tech is one of the vendors, it ensures standardization between vendors, and uniformity and collaboration among suppliers, thus working continuously towards meeting clients' business goals. This ensures the success of the deal. A typical deal-pursuit cycle is six months (excluding transition), which involves bid qualification, early collaboration, proposal, solution blueprint, customer visit, due diligence, contracting and, finally, transition.

HCL Tech is continuously working on bettering its relationship with its present clients as well as working its way through to new client wins. However, these relationships are formed, keeping in mind profitability, deal attractiveness, ability of the deal to scale up, clients' revenue, and more offshorisation. All this helps maintain a healthy P&L.

Anant Gupta provided us with insights into the company's success in the **infrastructure management business**. He talked about how HCL Tech has evolved from being a traditional ITO operator (all types of infrastructure services and applications) to a more focused managed services deliverer, then moving towards the new utilities (business process utility, utility computing, SaaS and Caas). Infrastructure deals, by their nature are sticky, with an average length of five years for HCL Tech. As a part of ITO services, HCL Tech provides a wide array of services including data center management, end user computing, network and security management, application, development and maintenance.

ITO service pricing trends for HCL Tech are moving towards being more output based (where a buyer's unit of consumption/volume of transaction is billed) from the traditional time and material (input-based) method. This provides HCL Tech with the flexibility to raise profitability in case of greater efficiency in execution. This then works in HCL's favor as its billing rates in deals contracted two to three years ago were lower than other large IT peers. With certain clients, it is also pushing for revenue-sharing for the costs it saves that client. Anand Gupta provided us with some deal examples: A server utilization deal (incentive-based) and telecoms (revenue-sharing).

Sandip Gupta explained the working of large deals. This helped us understand the manner in which HCL Tech **budgeted for them**. It helped us do away with the notion that HCL was bidding lower than its peers. For FY09, the company announced large deals of US$1.5bn. Such deals, though margin dilutive initially, offer better margins later due to greater efficiency. Such deals command higher margins not only due to greater offshorisation but also due to the transformation of clients' various business layers.

Pricing for large deals is done based on effort estimation, HCL's experience in similar deals, effort-volatility based on past customer/ industry data, robustness of customer data and depth, and customers' business environment. Key elements in pricing involve units of charging (most being done FTE based), fixed charges for baseline volumes, volume "guidance" and a minimum threshold.

HCL Tech's approach to emerging verticals (telecoms, the media publishing and entertainment), financial services and infrastructure services. Speakers for this session were Karan Puri (Sr. VP, Global Verticals head – Telecoms, Media and Entertainment), Premkumar S (Senior Corporate Officer & President, Financial Services – Strategic Businesses) and R Srikrishna (Global Sales and Marketing head).

Karan Puri spoke of the means by which the company was tackling the relatively "immature" vertical. 13,000+ consultants work for these verticals. HCL Tech has added 20+ new customers in FY08 and FY09. It offers complex solutions since it had earlier invested in solutions-based IPs. It is also looking at sharpening its focus on business partnerships. In FY09, the company has created a "funnel" of US$3.02bn, through which it has closed deals worth US$578m in FY09 alone. All this has ensured client wins like three of the top four music companies worldwide, four of the top five publishing companies worldwide, the top two gaming solutions providers, a leading US-based television network, a Europe-based tier I telecoms service provider, among others. MTV and the recently-won Readers' Digest Association fall in this category.

Challenges faced in these verticals include customer acquisition, service and retention, technology challenges hindering product deliveries, customer loyalty and operational improvement, customer experience driving rapid changes. To counter these challenges, HCL Tech is providing focused verticals-based solutions by breaking up the verticals into micro-verticals like communications service-providers – wireless, wire-line, telecom OEMs, publishing, business information services and broadcasting studios. HCL Tech is also investing in new domain-led services and focusing on moving up the value chain to further penetrate the verticals.

Premkumar S explained steps being taken to increase business traction in the matured vertical like **financial services (FS)**. The company added 18 clients in FY09, of which four deals were won in collaboration with strategic financial services product partners. The top 10 FS accounts grew 5% yoy. It established 50% yoy growth rates in APAC FS market with 11 new wins. All this has ensured clients such as eight of the top ten Australian banks, one of the top two investment managers, one of the top three global investment banks, the top retail bank in the UK, and three of the top ten insurance companies, among others.

In the financial services vertical, 26% of revenue came in from insurance, 39% from retail and corporate banking and the rest from capital markets.

Challenges in these verticals are external risks—liquidity crunch, competition and greater regulation—and internal (client) risks—low IT intensity, high cost-base, legacy assets and poor risk management. To counter these challenges, HCL Tech offers total a IT outsourcing solution with a sharper focus on cross-selling. It is increasing its domain expertise to provide greater customer satisfaction. This results in higher customer loyalty, advocacy, satisfaction and value. The company is also focusing on product/partnership-led propositions for deals, focusing on future technologies like cloud and utility computing for more complex deals. Its focus on emerging markets has resulted in an over 400% yoy growth in the top two Australia-New Zealand accounts.

R Srikrishna opened up to us the strategy to maintain traction in the infrastructure management business. HCL offered the following strategy to protect revenue in its present customers and to win new clients.

Fig 7 – Strategy for sustaining growth

Strategy	Impact on HCL Tech
Horizontalisation of services	Helps create more specialization
Spice programme 5*50*100 (proposition, clients, days)	Gain upsell and cross-sell revenue, new business in present customers
Customer advisory council	Enhance customer stickiness
Increase breadth and depth of services	Wider gamut of services that can be offered
Focus on large contracts	Increased profitability
Focus on renewal of contracts	Opportunity to position as the best vendor vis-à-vis others
Focused advisors' programme	Increased bid-to-win ratio differentiation
Increased global sales and marketing team	Promote cross-selling and best practices

Source : Company

As a result of all this, the company has recently won deals such as Readers Digest, Xerox, Dr Pepper Snapple in the US, Nokia in Europe and NIC in Asia.

A session was held by **Steve Cardell** (former CEO of Axon, now chief of HCL EAS) on strategies involving **EAS** as a practice for HCL-Axon after the acquisition. He spoke about the company's ability to bid for and win large deals, especially through leveraging its strengths in the RIM and EAS (HCL-Axon) services, pointing to the higher bid-to-win ratio after the Axon acquisition.

Fig 8 – Integration/ New order wins

Legacy Axon	Net new wins	Legacy HCL Tech
Utilities – US$250m	Health – US$100m	Consumer – US$78m
Utilities – US$28m	Public – US$40m	Consumer – US$50m
Consumer – US$15m	Retail – US$7.5m	Prof Service – US$1m
	Hi-tech – US$6m	Telecom – US$1.5m
		FS – US$5m
		Hi-tech – US$10m
YTD – US$293m	**YTD – US$153.5m**	**YTD – US$145.5m**

Source : Company

HCL-Axon acquired UCS in South Africa which had 65-70 specialized consultants. Due to this acquisition, HCL-Axon was able to clinch 17 of 18 SAP retail implementation projects in South Africa. Similarly, he said that HCL Tech was open to buying smaller companies to open up such opportunities in future.

He mentioned that the reasons for the success at HCL-Axon included low organizational attrition, the Axon team being retained, market wins boosting confidence, alignment with HCL Tech's structure, cross-selling services and an integrated delivery model.

Our View

Management's emphasis on the outlook for EAS and RIM services supports our positive view of these horizontals and their contribution to the company's growth. HCL Tech's sharper focus on and strategy in winning large deals (with differentiated pricing and protection of profitability) support our view of its ability to bid for and win such deals, especially through leveraging its strengths in the RIM and EAS (HCL-Axon) services.

For new practices, HCL Tech is aggressively taking steps such as expanding the sales and marketing teams, and building delivery centres for future technologies. This would clearly indicate that it is getting ready for the next level of competition.

We therefore re-rate HCL Tech from 15x FY11e earnings to 17x, chiefly because of its greater focus on clients, technologies and profitability. We maintain our estimates for FY10/11. Hence, we increase our target price to Rs425 (17x FY11e earnings of Rs25). We maintain our Buy rating.

At the target multiple of 17x, HCL Tech would trade at a 23% discount to Infosys' target multiple of 22x. In the past, the stock has traded at a 28% discount to Infosys. This gap between Infosys and HCL Tech would reduce on account of reduction in the gap between their revenues. HCL Tech had a revenue of 43% that of Infosys in FY07 vis-à-vis our expectation of 55% in FY10.

Appendix 1

Analyst Certification

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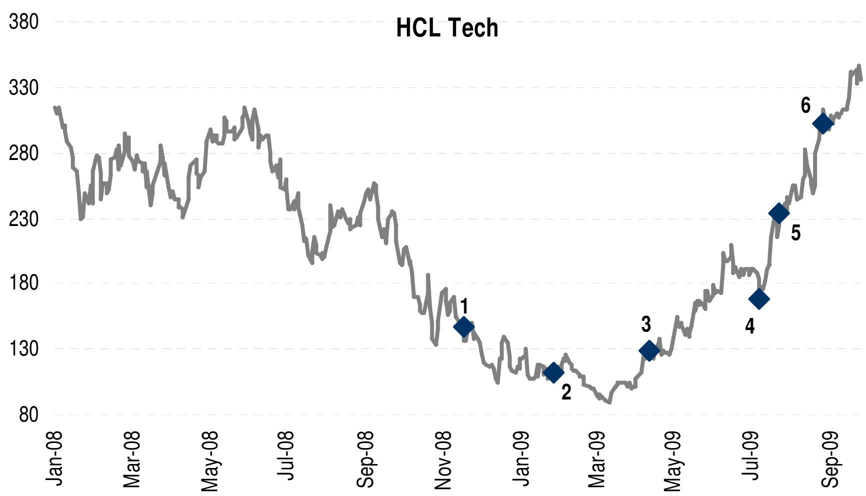
Important Disclosures on subject companies

Rating and Target Price History (as of 26 Sept 2009)



	Date	Rating	TP (Rs)	Share Price
1	17-Nov-08	Sell	135	157
2	27-Jan-09	Hold	120	107
3	13-Apr-09	Hold	135	122
4	8-Jul-09	Hold	195	168
5	24-Jul-09	Buy	320	225
6	26-Aug-09	Buy	375	307

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Ratings Guide	Buy	Hold	Sell
Large Caps (>US$1bn)	>20%	5-20%	<5%
Mid/Small Caps (<US$1bn)	>30%	10-30%	<10%

Anand Rathi Research Ratings Distribution (as of 29 Jul 09)	Buy	Hold	Sell
Anand Rathi Research stock coverage (87)	43%	13%	44%
% who are investment banking clients	9%	0%	0%

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