

COMPANY

UPDATE

HCL Technologies Ltd.

Margin overview stays on course

BUY

Analyst

Pratik Gandhi

+91-22-4322 1367

pratik.gandhi@idbicapital.com

Nifty: 5,910; Sensex: 19,687

CMP	Rs487
Target Price	Rs585
Potential Upside/Downside	+20%

Key Stock Data

Sector	IT Services
Bloomberg / Reuters	HCLT IN / HCLT.BO
Shares o/s (mn)	697
Market cap. (Rs mn)	339,439
Market cap. (US\$ mn)	7,636
3-m daily average vol.	1,07,170

Price Performance

52-week high/low	Rs518/338		
	-1m	-3m	-12m
Absolute (%)	5	3	35
Rel to Sensex (%)	(1)	6	25

Shareholding Pattern (%)

Promoters	64.8
FII/IRIs/OCBs/GDR	23.3
MFs/Banks/FIs	5.8
Non Promoter Corporate	3.0
Public & Others	3.1

Relative to Sensex



Summary

We had a call with Mr. Ronit Dutta, Investor relations, HCL Technologies (HCLT). Post the call we continue to remain positive on the company as the focus on increasing market share is likely to continue and the company is “on track” to achieve margin guidance which has been a key issue for some time. The key takeaways are as follows: 1) The thrust on increasing market share likely to continue, but over next two quarters, focus would shift to improving margin over revenue growth. 2) March quarter growth to be in-line with peers (US\$ 3-4% QoQ) largely on account of one-time hit due to earthquake in Japan and revenue loss in BPO segment due to strategic alliance with Tangoe Inc. 3) The company is on track to equate AMJ11 EBIT margin to AMJ10 levels at 15.3% (versus Q2FY11 margin of 13.1%) on constant currency basis. The company expects large part of margin expansion in Q4FY11 as it's the best quarter historically (see Fig. 1). 4) For HCLT, Infrastructure management services (IMS) will continue to drive growth followed by core software, while BPO may decline during March quarter due to Tangoe Inc. 5) Employee addition is expected to remain strong due to robust demand. For HCLT, employee addition is more skewed towards laterals unlike its peers TCS and Infosys where focus is more on freshers for FY12. We expect 30% dollar growth in FY11E and 27% in FY12E. At CMP of Rs487 the stock is trading at 21.2x and 14.5x FY11E and FY12E earnings respectively. BUY stays with price target of Rs585 (25% discount to TCS's target multiple for FY12).

Key Highlights

In-line Mar quarter due to one-time hit because of Japan and alliance with Tangoe

HCLT's revenue growth in past few quarters was ahead of its peers - Wipro, Infosys and TCS (see table 1). However, the management foresees that the current quarter may not see the outperformance spree continue. The company expects in-line growth with peers (US\$ 3-4% QoQ) during March quarter due to one-time hit on account of Japan (3% of revenue) and revenue loss in BPO due to strategic alliance with Tangoe Inc. The company will have to bear one month's impact due to onsite revenue loss (1% of total rev.) in Japan due to earthquake while offshore (2% of total rev.) work didn't see any impact. Also, during the quarter the company entered into strategic alliance with Tangoe Inc, which will take over all onsite work in the area of telecom expense management for HCLT. However, HCLT will continue to provide offshore services to those clients. This will result in US\$3.6 mn revenue loss in the BPO segment. So net-net the company will lose ~US\$7 mn in revenue which will have an impact of 70bps on top-line (see table 2). However, this quarter favorable currency movement may partly offset this impact.

The company is “on track” to achieve margin guidance

The key concern on HCLT remains flat operating profit in past 5 quarters (see table 3). The current EBIT margin is 13.1% (Q2FY11). HCLT is on track to achieve AMJ11 margin equal to AMJ10 levels (15.3%) on constant currency basis (see Fig. 2). However, bulk of margin expansion is likely in Q4 as the current quarter will be impacted by 30-40bps due to Japan. There is likely margin expansion of 50-60bps in current quarter due to improvement in utilisation and SG&A rationalisation.

Outlook and Valuation

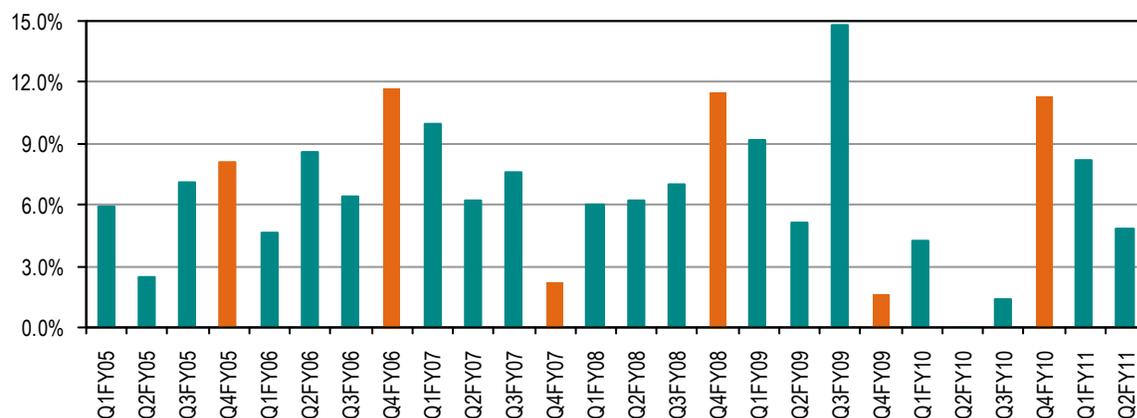
We are maintaining our EPS estimates for HCLT at Rs23.0 for FY11E and Rs33.5 for FY12E (6% higher than consensus). At CMP of Rs487, the stock is trading at 21.2x and 14.5x for FY11E and FY12E respectively. BUY stays with TP of Rs585 (25% discount to TCS's target multiple for FY12).

Financial snapshot

Year	Revenue	EBITDA	EBITDA (%)	Adj. PAT	EPS (Rs)	P/E (x)	EV/EBITDA (x)	RoE (%)	RoCE (%)
FY09	106,301	23,456	22.1	12,008	17.8	27.3	14.9	22.0	24.8
FY10	125,650	25,728	20.5	12,152	17.6	27.6	13.9	19.1	20.9
FY11E	160,119	27,165	17.0	16,004	23.0	21.2	13.4	20.8	21.1
FY12E	199,798	36,123	18.1	23,527	33.5	14.5	10.3	25.1	27.7

Source: Company; IDBI Capital Research

Figure 1: Q4 is typically the best quarter for HCLT in terms of top-line growth



Source: Company; IDBI Capital Research

Table 1: HCLT reported highest revenue growth amongst Big-4 in 6 out of 11 quarters

	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
TCS	0.5%	3.2%	-5.8%	-3.4%	3.3%	3.9%	6.3%	3.1%	6.4%	11.7%	7.0%
Infosys	1.1%	5.3%	-3.7%	-4.3%	0.1%	2.9%	6.8%	5.2%	4.8%	10.2%	5.9%
Wipro	3.5%	4.0%	-0.9%	-4.9%	-1.3%	3.2%	5.8%	3.5%	3.2%	5.7%	5.6%
HCLT	5.5%	0.1%	1.3%	10.3%	7.6%	3.8%	3.4%	5.1%	7.6%	9.0%	7.5%
Max	5.5%	5.3%	1.3%	10.3%	7.6%	3.9%	6.8%	5.2%	7.6%	11.7%	7.5%

Source: Company; IDBI Capital Research

Table 2: 70bps impact on Q3FY11 revenue due to earthquake in Japan and alliance with Tangoe Inc.

	US\$ mn
Revenue (a)	905.0
Japan (3% of total rev.) (b) = 3%*(a)	27.0
Onsite (1% of total rev.) (c) = 1%*(a)	9.0
Offshore (2% of total rev.) (d) = 2%*(a)	18.0
<i>Impact of Japan for 1 month</i>	
Onsite (1% of total rev.) (e) = (c)/3	3.0
<i>Impact due to Tangoe Inc. (f)</i>	
	3.6
Total impact (g) = (e) + (f)	6.6
Impact on revenue (in bps) (h) = (g)/(a)	70

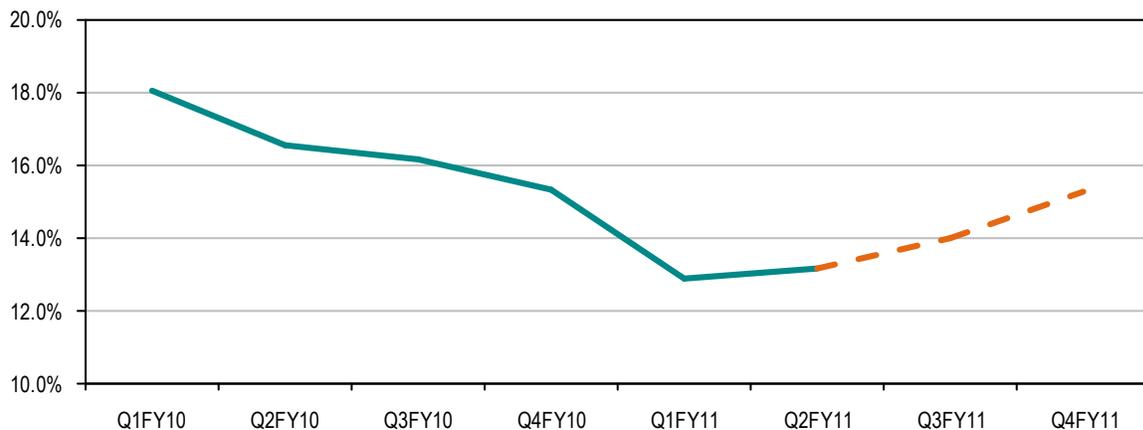
Source: Company; IDBI Capital Research

Table 3: Strong revenue growth, however flat operating profit for past 5 quarter remains as a concern

HCLT	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	5 qtr CQGR
Revenue	21,688	23,693	24,908	28,615	29,085	30,314	30,325	30,757	34,254	37,081	38,884	9.3%
EBITDA	5,084	5,311	5,601	6,103	6,441	6,888	6,386	6,073	6,381	6,034	6,347	2.5%

Source: Company; IDBI Capital Research

Figure 2: The company is "on track" to achieve margin guidance



Source: Company; IDBI Capital Research

Financial Summary

Profit & Loss Account

(Rs mn)

Year-end: June	FY09	FY10	FY11E	FY12E
Net sales	106,301	125,650	160,119	199,798
Growth (%)	39.1	18.2	27.4	24.8
Operating expenses	(82,845)	(99,922)	(132,955)	(163,674)
EBITDA	23,456	25,728	27,165	36,123
Growth (%)	38.5	9.7	5.6	33.0
Depreciation	(4,493)	(5,009)	(4,925)	(5,118)
EBIT	18,963	20,719	22,239	31,006
Other income	(3,671)	(5,302)	(528)	972
Pre-tax profit	15,292	15,417	21,711	31,978
Tax	(2,543)	(2,404)	(4,767)	(7,739)
Effective tax rate (%)	16.6	15.6	22.0	24.2
Net profit	12,749	13,013	16,945	24,239
Adjusted net profit	12,008	12,152	16,004	23,527
Growth (%)	16.1	1.2	31.7	47.0
Shares o/s (mn nos)	673	689	697	702

Balance Sheet

(Rs mn)

Year-end: June	FY09	FY10	FY11E	FY12E
Net fixed assets	69,795	71,248	71,470	72,280
Investments	370	707	707	707
Current assets	56,777	63,760	65,454	80,769
Sundry Debtors	27,083	30,496	35,095	45,433
Cash and Bank	4,203	4,686	3,665	5,254
Total assets	126,942	135,715	137,630	153,756
Shareholders' funds	56,862	70,368	83,654	103,745
Share capital	1,335	1,348	1,368	1,378
Reserves & surplus	55,511	69,005	82,271	102,353
Total Debt	37,405	34,018	22,647	13,983
Curr Liab & prov	32,675	31,329	31,329	36,028
Total liabilities	70,080	65,347	53,976	50,011
Total equity & liabilities	126,942	135,715	137,630	153,756
Book Value (Rs)	84	102	120	148

Source: Company; IDBI Capital Research

Financial Ratios

Year-end: June	FY09	FY10	FY11E	FY12E
Adj EPS (Rs)	17.8	17.6	23.0	33.5
Adj EPS growth (%)	14.6	(1.2)	30.3	46.0
EBITDA margin (%)	22.1	20.5	17.0	18.1
Pre-tax margin (%)	14.4	12.3	13.6	16.0
ROE (%)	22.0	19.1	20.8	25.1
ROCE (%)	24.8	20.9	21.1	27.7
Turnover & Leverage ratios (x)				
Asset turnover	1.0	1.0	1.2	1.4
Leverage factor	1.9	2.1	1.8	1.6
Net margin (%)	11.3	9.7	10.0	11.8
Net Debt/Equity (x)	0.4	0.3	0.3	0.3
Working Capital & Liquidity ratio				
Receivable days	93	89	80	83

Valuation

Year-end: June	FY09	FY10	FY11E	FY12E
PER (x)	27.3	27.6	21.2	14.5
Price / Book value (x)	5.8	4.8	4.1	3.3
PCE (x)	19.9	19.5	16.2	11.9
EV / Net sales (x)	3.3	2.9	2.3	1.9
EV / EBITDA (x)	14.9	13.9	13.4	10.3
Dividend Yield (%)	1.4	0.8	0.8	1.0



Notes

Vikrant Oak – Head Institutional Equities	(91-22) 4322 1385	vikrant.oak@idbicapital.com
Sonam H. Udasi – Head Research	(91-22) 4322 1375	sonam.udasi@idbicapital.com
Dealing	(91-22) 4322 1150	dealing@idbicapital.com

Key to Ratings**Stocks:**

BUY: Absolute return of 15% and above; **ACCUMULATE:** 5% to 15%; **HOLD:** Upto $\pm 5\%$; **REDUCE:** -5% to -15%; **SELL:** -15% and below.

IDBI Capital Market Services Ltd. (A wholly owned subsidiary of IDBI Ltd.)

Registered Office: 5th floor, Mafatlal Centre, Nariman Point, Mumbai – 400 021. Phones: (91-22) 4322 1212 Fax: (91-22) 2285 0785 Email: info@idbicapital.com

Disclaimer

This document has been prepared by IDBI Capital Market Services Ltd (IDBI Capital) and is meant for the recipient only for use as intended and not for circulation. This document should not be reproduced or copied or made available to others. No person associated with IDBI Capital is obligated to call or initiate contact with you for the purposes of elaborating or following up on the information contained in this document.

Recipients may not receive this report at the same time as other recipients. IDBI Capital will not treat recipients as customers by virtue of their receiving this report.

The information contained herein is from the public domain or sources believed to be reliable. While reasonable care has been taken to ensure that information given is at the time believed to be fair and correct and opinions based thereupon are reasonable, due to the very nature of research it cannot be warranted or represented that it is accurate or complete and it should not be relied upon as such. In so far as this report includes current or historical information, it is believed to be reliable, although its accuracy and completeness cannot be guaranteed.

Opinions expressed are current opinions as of the date appearing on this material only. While we endeavor to update on a reasonable basis, the information discussed in this material, IDBI Capital, its directors, employees are under no obligation to update or keep the information current. Further there may be regulatory, compliance, or other reasons that prevent us from doing so.

Prospective investors and others are cautioned that any forward-looking statements are not predictions and may be subject to change without notice.

IDBI Capital, its directors and employees and any person connected with it, will not in any way be responsible for the contents of this report or for any losses, costs, expenses, charges, including notional losses/lost opportunities incurred by a recipient as a result of acting or non acting on any information/material contained in the report.

This is not an offer to sell or a solicitation to buy any securities or an attempt to influence the opinion or behaviour of investors or recipients or provide any investment/tax advice.

This report is for information only and has not been prepared based on specific investment objectives. The securities discussed in this report may not be suitable for all investors. Investors must make their own investment decision based on their own investment objectives, goals and financial position and based on their own analysis.

Trading in stocks, stock derivatives, and other securities is inherently risky and the recipient agrees to assume complete and full responsibility for the outcomes of all trading decisions that the recipient makes, including but not limited to loss of capital.

Opinions, projections and estimates in this report solely constitute the current judgment of the author of this report as of the date of this report and do not in any way reflect the views of IDBI Capital, its directors, officers, or employees.

This report is not directed or intended for distribution to, or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject IDBI Capital and affiliates to any registration or licensing requirement within such jurisdiction. The securities described herein may or may not be eligible for sale in all jurisdictions or to certain category of investors. Persons in whose possession this document may come are required to inform themselves of and to observe such restriction.

IDBI Capital, its directors or employees or affiliates, may from time to time, have positions in, or options on, and buy and sell securities referred to herein. IDBI Capital or its affiliates, during the normal course of business, from time to time, may solicit from or perform investment banking or other services for any company mentioned in this document or their connected persons or be engaged in any other transaction involving such securities and earn brokerage or other compensation or act as a market maker in the financial instruments of the company(ies) discussed herein or their affiliate companies or act as advisor or lender / borrower to such company(ies)/affiliate companies or have other potential conflict of interest.

This report may provide hyperlinks to other websites. Except to the extent to which the report refers to the website of IDBI Capital, IDBI Capital states that it has not reviewed the linked site and takes no responsibility for the content contained in such other websites. Accessing such websites shall be at recipient's own risk.

E-mail is not a secure method of communication. IDBI Capital Market Services Limited cannot accept responsibility for the accuracy or completeness of any e-mail message or any attachment(s). This transmission could contain viruses, be corrupted, destroyed, incomplete, intercepted, lost or arrive late. IDBI Capital, its directors or employees or affiliates accept no liability for any damage caused, directly or indirectly, by this email.