

HCL Technologies Ltd (Q3 F6/08)

April 16, 2008

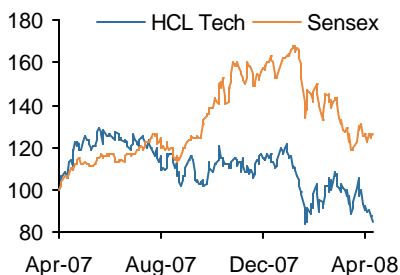
Stock data

Sensex:	16,154
CMP (Rs):	246
Target price (Rs):	283
Upside (%):	15.0
52 Week h/l (Rs):	365/180
Market cap (Rs cr)	16,517
6m Avg vol BSE&NSE ('000 nos):	1,172
No of o/s shares (mn):	671
FV (Rs):	2
Bloomberg code:	HCLT IN
Reuters code:	HCLT.BO
BSE code:	532281
NSE code:	HCLTECH

Shareholding pattern

December 2007	(%)
Promoters	67.5
FII's	16.8
Indian institutions	6.0
Public & others	9.7

Share price trend



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- HCL reports a lower than expected 5.2% qoq dollar revenue growth. Volume growth slows down though pricing improvements continue.
- Core software services registers solid growth of 6.5% qoq while IMS and BPO revenues grow by sluggish 1.5-2% qoq.
- EBITDA margin expands by 90bps qoq to 22.3% driven by improved realizations, higher utilization, SG&A leverage and offshore shift. Core software services margin improves by 95 bps.
- Lower other income, due to forex loss, leads to a net profit growth of just 1.1%.
- Management maintains F6/08 revenue growth outlook at 35% yoy on a reduced headcount target. Company expects a modest Q4 F6/08.
- Reiterate BUY on HCL Tech with a price target of Rs283 implying 15% upside.

Result table

Period to (Rs mn)	Q2 F6/08 (3)	Q3 F6/08 (3)	QoQ (%)	YoY (%)
Net sales	18,166	19,448	7.1	23.3
Total Expenditure	(14,281)	(14,281)	0.0	18.0
EBIDTA	3,885	4,331	11.5	18.1
EBITDA margin (%)	21.4	22.3	-	-
Depreciation	(724)	(773)	6.8	17.3
Interest	-	-	-	-
Other income	542	228	(57.9)	(62.9)
PBT	3,703	3,786	2.2	4.5
Tax	(355)	(368)	3.7	30.0
Income from Equity Affiliates	-	-	-	-
Minority Interest	(21)	7	-	-
PAT	3,327	3,425	2.9	3.3
ESOP charge	(222)	(219)	(1.4)	(28.2)
APAT	3,105	3,206	3.3	6.4
Number of shares (Mn)	663.4	663.4	-	-
EPS (Rs)	5.0	5.2	2.9	3.3

Source: Company, India Infoline Research

Revenue growth momentum slows down but outlook remains healthy

After reporting eighth consecutive quarters of strong 7%+ qoq growth in dollar revenues, HCL reports a slower growth of 5.2% qoq in Q3 F6/08. The 5.2% growth comprised of 5-5.5% volume growth, 0.9% improvement in average realizations and negative impacts of forex and offshore shift. On yoy basis, revenue growth remained strong at 34% yoy. Based on a convenience translation basis, rupee revenues grew by 7.1% qoq. HCL Tech re-affirmed its leadership position in winning large deals by closing five deals in Q3 F6/08 worth US\$500mn. These deals are spread across telecom, financial services, Hi-Tech verticals and the US, Europe and Australia geographies. This, in addition to many large deals won in the past 12-15 months, provides better-than-peer revenue visibility to HCL. However, management mentioned about two of the Top 10 clients having frozen their IT budgets for CY08 implying zero revenue growth in these accounts during the year.

Core software led revenue growth in the quarter

Dollar revenue growth in core software remained strong at 6.5% qoq driven by 5.3% volume growth, material 1.6% billing rate improvement and 0.4% negative impact from offshore shift. There was a 20bps offshore shift during the quarter. There was a sharp decline in growth in IMS revenues by 1.5% qoq. This was due to absence of one-time material revenues present in Q2 F6/08. However, volume growth in non-material services revenues was strong at 8.5% qoq. BPO revenues grew by 2% qoq after remaining flat last quarter. The growth comprised of 4.5% volume growth and 2.6% decline in realizations. In the last couple of quarters, the BPO business was impacted by a slowdown in revenues from a key client who contributed 5% of segmental revenues in Q1 F6/08.

Revenues from US and engineering and R&D services continue to grow strongly; BFSI reports lower growth

Revenue growth in the US region has been consistently strong for HCL tech over the last four quarters with CQGR of 8.4%. In Q3 F6/08, dollar revenues grew at 6.9% qoq, far ahead of the company. BFSI revenues registered a lower growth of 2.3% qoq. However, last four quarter CQGR stood strong at 8.4%. Hi-Tech and Telecom verticals grew sequentially by high 8.9% and 7.1% respectively. Amongst services, engineering and R&D and custom applications led growth by clocking qoq revenue increases of 7.3% and 7.5% respectively.

EBITDA margin improve 90bps qoq to 22.3%

EBITDA margin improved materially by 90bps in Q3 F6/08 driven by improved realizations, higher utilization, SG&A leverage and offshore shift. On segmental basis, core software and IMS recorded EBITDA margin improvements of 95 bps and 100 bps qoq respectively. While margin expansion in core software segment was mainly driven by higher pricing and utilization, it was due to lower share of low-margin material revenues in the IMS segment.

Other income declines as company reports mark-to-market loss on forex cover

During the start of the quarter, HCL Tech had a significant forex cover in excess of US\$2bn. The mark-to-marking of this cover at the quarter-ending Re/\$ rate lead to a loss of Rs270mn. Treasury income was slightly higher than previous quarter at Rs500mn. Overall, the other income was 58% lower qoq at Rs228mn due to the forex loss. As a result, net profit growth was lower than revenue growth at 1.1% in dollar terms and 2.9% in rupee terms

Modest manpower addition while continued decline in attrition is commendable

During the quarter, company added net 1,848 people; 3.9% of Q2 F6/08 ending workforce. There was a small decline in core software headcount as company focused on utilization of about 2,500 people added towards the end of the previous quarter. Further, the revenue share of IPs/products increased significantly on qoq basis within the segment. In BPO, there was a significant addition of resources (1,374 people, 12% of Q2 F6/08 base) indicating strong revenue growth expectations. Attrition for the company declined for the sixth consecutive quarter. It was 15.2% in IT services (core software + IMS) and 12% (quarterly) in BPO.

Maintains F6/08 revenue growth outlook at 35% on a reduced headcount target

HCL Tech maintained its dollar revenue growth outlook for the year at 35% yoy despite strong performance in 9m F6/08 (38% yoy growth) factoring a modest Q4 F6/08 due to difficult macro environment and flattish growth expectations from couple of large clients mentioned above. Buoyed by improving revenue productivity from changing offerings mix and increasing IP/product revenues, company is now confident of achieving the revenue guidance by addition of lower 9,000 (earlier 12,000) employees. Company expects a 3-4% dollar revenue growth and stable EBITDA margin in Q4 F6/08.

Reiterate BUY with a price target of Rs283 implying 15% upside

We believe that HCL Tech has built a resilient business model and has high revenue visibility making it better equipped than peers to survive any short-term business challenges. We reiterate a BUY on HCL Tech with a one-year price target of Rs283 (based on 13x march-adjusted FY09 EPS of Rs21.8) implying 15% upside.

Projected financials

y/e June (Rs mn)	F6/06	F6/07	F6/08E	F6/09E	F6/10E
Revenues	43,882	60,336	74,908	91,918	113,530
yoy growth (%)	32.1	37.5	24.2	22.7	23.5
EBITDA	9,729	13,370	16,276	19,176	22,594
EBITDA margin (%)	22.2	22.2	21.7	20.9	19.9
PAT	7,077	12,592	12,672	14,268	15,326
PAT	7,077	12,592	12,672	14,268	15,326
yoy growth (%)	17.8	77.9	0.6	12.6	7.4
EPS (Rs)	10.9	19.0	18.9	21.0	22.6
P/E (x)	22.5	13.0	13.0	11.7	10.9
P/BV (x)	3.9	3.4	3.1	2.7	2.4
EV/EBITDA (x)	14.4	10.4	8.6	7.2	5.9
ROE (%)	17.4	26.3	23.5	23.3	21.9
ROCE (%)	23.4	35.0	30.7	31.2	31.6

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