

Company

25 August 2009 | 9 pages

HCL Technologies (HCLT.BO)

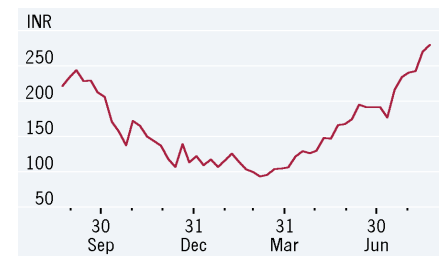
Equity

Hold: Good Q4 but Another Decline in IT Services Headcount

- **~8% sequential revenue growth led by infra services** — HCL Tech reported strong Q4FY09 results – revenues increased ~7.6% sequentially with infrastructure services leading the way with 25.5% growth sequentially. Margin improvement of ~80bps qoq and lower than expected forex losses resulted in net profits increasing ~50% qoq to Rs. 3.1b.
- **Margins improved ~82 bps qoq** — EBITDA margins improved ~80bps sequentially. IT Services margins improved by ~180bps sequentially due to better realizations and utilization rates. BPO and Infrastructure services margins declined sequentially.
- **Decent growth across segments** — HCL Tech reported decent growth across segments – software services revenue growth was 4.5%, which was meaningfully better than peers. Infrastructure services did very well with ~25% sequential growth while BPO did well with ~4% growth qoq.
- **IT Services headcount declines again** — IT Services headcount declined yet again – delivery headcount declined by ~500 employees compared to a decline of ~300 reduction in the previous quarter. Management comments on growth outlook for software services remain a key to focus on.
- **More details post the earnings call** — The strong set of results will likely result in EPS upgrades across the street. The key issues to focus in the earnings call are (a) Demand outlook for IT services given the headcount reduction and (b) Sustainability of margins. The earnings call is at 1730 hrs India time.

Hold/Medium Risk	2M
Price (24 Aug 09)	Rs289.30
Target price	Rs215.00
Expected share price return	-25.7%
Expected dividend yield	1.4%
Expected total return	-24.3%
Market Cap	Rs193,905M US\$4,004M

Price Performance (RIC: HCLT.BO, BB: HCLT IN)



Statistical Abstract

Year to	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
30 Jun							
2007A	12,577	18.43	76.2	15.7	3.8	27.7	2.8
2008A	10,323	15.16	-17.7	19.1	3.7	20.2	3.1
2009E	10,791	16.02	5.7	18.1	3.8	20.9	2.4
2010E	9,175	13.70	-14.5	21.1	3.4	17.0	1.4
2011E	11,497	17.16	25.3	16.9	3.0	18.9	2.1

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.

Result Tables

Figure 1. Key Highlights

Rs m	4Q08	3Q09	4Q09	QoQ	YoY
Revenue (US\$ m)	504	564	607	7.6%	20.5%
Revenue	21,688	28,615	29,085	1.6%	34.1%
Cost of revenue	12,910	18,009	18,136	0.7%	40.5%
Gross profit	8,778	10,606	10,949	3.2%	24.7%
Gross margin	40.5%	37.1%	37.6%	58bp	-283bp
Operating expenses	3,694	4,503	4,508	0.1%	22.0%
EBITDA	5,084	6,103	6,441	5.5%	26.7%
EBITDA margin	23.4%	21.3%	22.1%	82bp	-130bp
Dep & amortz.	850	1,417	1,197	-15.5%	40.8%
EBIT	4,234	4,686	5,244	11.9%	23.9%
EBIT margin	19.5%	16.4%	18.0%	165bp	-149bp
Other income	-2,644	-2,040	-1,002	-50.9%	-62.1%
Profit before tax	1,590	2,646	4,242	60.3%	166.8%
Income tax expense	203	485	935	92.8%	360.6%
Income from operations	1,387	2,161	3,307	53.0%	138.4%
Affiliates/Minority	23	17	-4	-123.5%	-117.4%
Net income - recurring	1,410	2,178	3,303	51.7%	134.3%
EO income/(loss)	-231	-183	-212	15.8%	-8.2%
Net profit	1,179	1,995	3,091	54.9%	162.2%
EPS - basic	2.12	3.25	4.93	51.6%	132.7%
EPS - diluted	2.07	3.25	4.90	50.6%	137.1%

Source: Company Reports

Figure 2. Segment Financials

	1Q09	2Q09	3Q09	4Q09
HCL Tech - consolidated				
Revenue (Rs m)	23,693	24,909	28,615	29,084
Change - qoq	9.2%	5.1%	14.9%	1.6%
EBITDA margin	22.4%	22.5%	21.3%	22.1%
Change - qoq	-103bp	7bp	-116bp	82bp
IT services				
Revenue (Rs m)	17,301	17,697	21,430	21,148
Change - qoq	8.3%	2.3%	21.1%	-1.3%
EBITDA margin	23.7%	24.7%	22.0%	23.8%
Change - qoq	4bp	96bp	-267bp	176bp
Infrastructure services				
Revenue (Rs m)	3,709	4,115	4,328	5,130
Change - qoq	13.1%	10.9%	5.2%	18.5%
EBITDA margin	18.9%	19.6%	22.0%	19.4%
Change - qoq	18bp	64bp	239bp	-259bp
BPO services				
Revenue (Rs m)	2,683	3,097	2,857	2,806
Change - qoq	10.3%	15.4%	-7.7%	-1.8%
EBITDA margin	18.9%	13.9%	15.3%	15.0%
Change - qoq	-942bp	-494bp	141bp	-33bp

Source: Company Reports

Figure 3. Key Client Metrics

	1Q09	2Q09	3Q09	4Q09
Client relationships				
US\$1m clients	205	218	256	253
US\$5m clients	68	68	81	85
US\$10m clients	36	39	40	43
US\$20m clients	17	19	19	20
US\$30m clients	12	12	11	8
Client concentration				
Top 5 Clients	26.1%	25.3%	22.7%	20.6%
Top 10 Clients	36.6%	35.1%	31.9%	28.9%
Top 20 Clients	48.8%	47.9%	43.6%	40.2%

Source: Company Reports

Figure 4. Revenue Mix

	1Q09	2Q09	3Q09	4Q09
Service Offering				
R&D and Engg services	26.3%	25.6%	22.0%	19.4%
Enterprise App services	10.9%	12.5%	24.5%	23.6%
Application services	35.8%	32.8%	28.4%	29.7%
Infrastructure services	15.7%	16.7%	15.1%	17.6%
BPO services	11.3%	12.4%	10.0%	9.7%
Geography				
US	57.3%	59.5%	61.0%	58.9%
Europe	28.7%	27.3%	27.6%	28.5%
AsiaPac	13.9%	13.2%	11.4%	12.6%
Verticals				
BFSI	27.5%	27.7%	23.6%	24.8%
Manufacturing, Hi-Tech	30.7%	30.0%	30.3%	30.9%
Telecom	16.5%	15.8%	12.1%	12.5%
Retail	8.2%	7.7%	6.9%	6.6%
Media and Entertainment	5.6%	5.5%	5.0%	5.6%
Life Sciences	5.9%	5.9%	6.3%	6.4%
Others	5.6%	7.4%	15.8%	13.2%

Source: Company Reports

Figure 5. Key HR & Execution Metrics

	1Q09	2Q09	3Q09	4Q09
Total manpower	52,714	55,018	54,026	54,216
Net addition	1,973	2,304	-992	190
A. Software services				
Total manpower	31,271	33,298	32,902	32,364
Delivery	27,282	29,174	28,887	28,353
Support	3,989	4,124	4,015	4,011
B. BPO services				
Total manpower	13,164	12,750	11,426	11,800
Delivery	11,668	11,096	9,996	10,421
Support	1,496	1,654	1,430	1,379
C. Infrastructure services				
Total manpower	8,279	8,970	9,698	10,052
Delivery	7,413	8,091	8,779	9,191
Support	866	879	919	861
Efforts - IT services				
Billed	66,247	66,984	70,588	70,662
- offshore	49,603	50,419	50,539	50,640
- onsite	16,644	16,565	20,049	20,022
Unbilled	17,427	17,286	18,401	16,179
Trainees	213	426	75	276
Utilization - IT services				
Offshore	74.4%	74.5%	74.1%	76.2%
Offshore ex trainees	74.7%	75.0%	74.8%	76.5%
Onsite	96.5%	97.4%	96.4%	97.0%
Revenue Mix - IT services				
- offshore	52.0%	53.5%	41.1%	41.2%
- onsite	48.0%	46.5%	58.9%	58.8%
Attrition				
IT services - LTM	14.2%	13.4%	13.1%	12.9%
BPO - quarterly	16.0%	12.7%	14.8%	12.6%
Infrastructure services - LTM	14.3%	13.5%	13.5%	13.2%

Source: Company Reports

HCL Technologies

Company description

HCL Technologies (HCLT) is the fifth-largest Indian IT services company. Founded in 1991, HCLT focused on technology and R&D outsourcing before diversifying into enterprise applications. In the infrastructure business, it has been gradually shifting focus from domestic sales to global services. In BPO, it is one of the largest offshore service providers and boasts strong ties with British Telecom. The company leverages off its extensive offshore infrastructure and its global network to deliver solutions across verticals including Banking, Insurance, Retail, Consumer, Aerospace, Automotive, Semiconductors, Telecom and Life Sciences. HCLT has ~350 clients across verticals and a workforce of more than 50,000.

Investment strategy

We rate HCLT shares Hold/Medium Risk (2M). HCLT has been at the forefront of pursuing large deals - has announced ~US\$1.5b of large deals in 9MFY09 (~US\$1b in FY08). Significant presence across IT services, BPO services and IMS has helped HCLT qualify for multi-year outsourcing deals. IMS, R&D and

BPO service offerings should enable it to post strong revenue growth. The recent Axon acquisition helps HCLT in filling up the gap in Enterprise services, where HCLT was lagging peers. However, it faces near-term challenges as Axon's business is cyclical and margins could be hit significantly in the downturn. We forecast ~11% revenue and ~4% EPS CAGR over FY08-11E.

Valuation

Our target price is Rs215 based on 14x FY10-11E average EPS. This is towards the mid-point of the 6-23x band that the stock has traded in over the past 3-years. We believe a higher multiple is not justified given macro headwinds and potential integration issues arising out of Axon, and a lower multiple is not warranted as business has bottomed out. We believe P/E remains the most appropriate valuation measure given HCLT's profitable track record.

Risks

We rate HCLT Medium Risk despite our quantitative risk-rating system suggesting High Risk as the company has significant scale, enjoys a good brand name and continues to generate significant FCF. Key downside risks include: 1) any significant appreciation of the rupee against the USD/EUR/GBP; 2) a sharp slowdown in the US/Global economy; 3) acquisition-related risks; and 4) the strategy of pursuing large deals could have negative margin implications. Key upside risks include: 1) any significant depreciation of the rupee against the USD/EUR/GBP; 2) bounce-back in the US/Global economy; and 3) favorable H1-B visa quota regime. These risks could cause the stock to deviate from our target price.

Appendix A-1

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HCL Technologies (HCLT.BO)

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Fundamental Research

Analyst: Surendra Goyal, CFA
Covered since October 5 2006

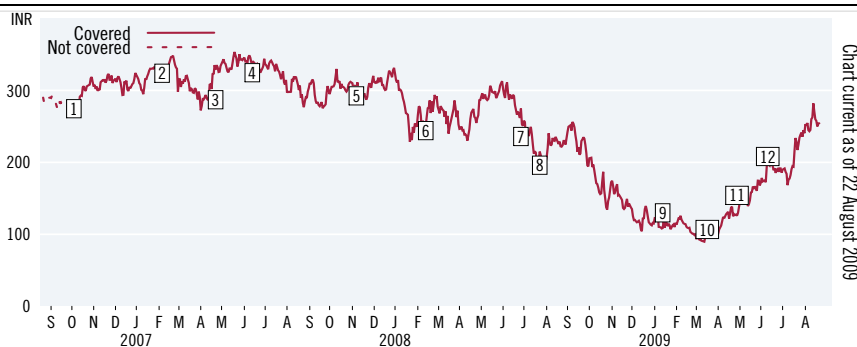


Chart current as of 22 August 2009

	Date	Rating	Target Price	Closing Price
1	4-Oct-06	*1M	*340.00	276.70
2	6-Feb-07	1M	*385.00	328.33
3	23-Apr-07	1M	*405.00	329.05
4	13-Jun-07	1M	*400.00	336.95

	Date	Rating	Target Price	Closing Price
5	7-Nov-07	1M	*365.00	295.35
6	13-Feb-08	1M	*340.00	251.45
7	26-Jun-08	1M	*350.00	274.80
8	23-Jul-08	1M	*245.00	214.95

	Date	Rating	Target Price	Closing Price
9	13-Jan-09	*2H	*120.00	108.60
10	17-Mar-09	2H	*111.00	101.15
11	28-Apr-09	*2M	*140.00	125.85
12	10-Jun-09	2M	*215.00	204.40

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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