HCL Technologies HCLT.NS HCLT IN

SOFTWARE & SERVICES

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EQUITY RESEARCH

Takeaways from our interaction with management

First Look

Breaking news, market events and company announcements

November 25, 2011

Rating Remains	**Buy**
Target price Remains	INR 530
Closing price November 24, 2011	INR 393

We summarize below key highlights of HCL Tech management views on demand and margins:

Looking to reinvest excess of stated 14% margin to drive higher growth

Margins made above its guided levels of 14% will be redeployed in the business to drive higher growth. The investments would be made in 1) sales 2) solutions/platforms and 3) Passing on benefits of rupee depreciation to customers for large long term assured business on select deals.

Rupee depreciation benefit to be passed to customers on select deals: HCL Tech is looking to price new deals at USD-INR rates of 48-49 (vs 45-46 earlier), whereby the company makes 14% margin and gives the benefit of rupee depreciation to the client. HCL Tech would protect itself against future rupee appreciation by taking long term hedges over the deal duration, as getting longer terms hedges is not an issue according to the management (current USD/INR forward premium is at ~3-3.5%, which leaves some rupee depreciation benefit to HCL Tech). The company indicates this would not be a blanket policy, but could apply to larger transactions which provide 3-5 years of significant visibility or situations where HCL Tech needs to pay entry ticket premium to get a look in. The company is confident that at renewal of these deals, the contract structuring would ensure that they make similar margins even in a rupee appreciation scenario. HCL says it is taking advantage of the rupee volatility by giving customers the benefit.

Employee pyramid more a long term lever: Increasing fresher proportions is a long term margin lever according to the company. (HCL Tech has been hiring ~80% laterals in the past, which have over the last two quarters come down to 55-60% levels). HCLT currently has training centre at Manesar and is building one at Nagpur, which will have capacity of 5000-6000 people to be trained at one go (completion over the next 3 years). Utilisation including trainees is a marginal lever according to the company and can move up by 100-200bps.

Demand outlook continues to be strong, deal signings on track

Increased offshoring due to crisis: Euro crisis and weak global macro is leading to 1) increased outsourcing and 2) higher vendor churn as customers look to cut costs more and fund change-the-business projects (CTB) from savings from run-the-business (RTB) projects. Most of the vendor churn is happening on the Application management outsourcing side. In BPO/SAP projects no major vendor change is happening. Vendor management functions are ill developed in large organisations as they have too many vendors and this is being re-assessed.

Indian offshore vendors gaining market share: Indian vendors are gaining market share as a result of consolidation and vendor churn. Indian offshore providers (IOP) have increased market share from 12% to 17% over the last 2-3 years. Vendor change is happening on 1) better

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pricing 2) better flexibility. Global vendors are less flexible than Indian vendors as the cost of redeployment of resources is high. In contrast, IOP's can be flexible as the growth rate is high and resources can easily be redeployed.

Deal activity robust but vendors cautious on announcements: OND'11 will be biggest quarter in terms of deal decision making. TPI indicates that HCL is among the top 6 vendors across all regions. Despite robust deal activity, deal win announcements might be limited as it remains a sensitive subject for vendors/clients in the current high unemployment scenario in developed markets. HCLT says its deal-win ratio is better than that during 2008. According to the company, the revenue impact of the deal pipeline will be seen in the AMJ quarter (4QFY12); OND quarter will see normal seasonality; BFS and Manufacturing continue to see a good pipeline; while stress in the Telecom vertical continues.

CTB activity has dried out: 50% of HCL Tech business comes from CTB work. Cost cutting is not a trigger in CTB as work can't be moved offshore because it is higher up the value chain.

SAP license growth mostly in analytics and not ERP: According to the management, most of the SAP new license growth is being driven by analytics – which are short term spends. The implementation work on analytics licenses is only 0.7x of the license fee, unlike ~3x in ERP rollouts. This trend does not benefit HCL Tech's Axon piece, which is purely core ERP work. Analytics and middleware is reported under Custom applications for HCL Tech.

Nomura view:

- We remain convinced about HCL Tech's large deal winning prowess and revenue surety stemming from the 1) biggest deal pipeline and better deal win rates than the company is guiding for and 2) the ramp-up in 32 transformational deals signed over the past 2 quarters. Management commentary on deal signings and pipeline was reassuring.
- Management intention of reinvesting excess margins into sales investments to drive higher growth is acceptable, if it generates desired results the stock can re-rate, in our view.
- However, we view HCL Tech's intention of passing the benefits of rupee depreciation to clients to gain market share on select deals as a negative. This practise comes with an additional risk of lower reported EBIT margins, if discounting becomes widespread. This is because the company is expected to price deals at ~49 USD/INR and then hedge it; if the rupee were to appreciate, gross margins would be lower, while gains on the hedges would be reported at the forex line (below EBIT). We will be watching gross margin movements at HCL Tech to ascertain if this practice is becoming widespread and going against management statements. Our current assumptions build in flattish margin expectations at ~14% over FY12-13F.

We expect US$ revenue CAGR of 18% and EPS of CAGR of 24% over FY11-13F and find the stock attractively valued at ~11x FY13F earnings. Maintain Buy.

Appendix A-1

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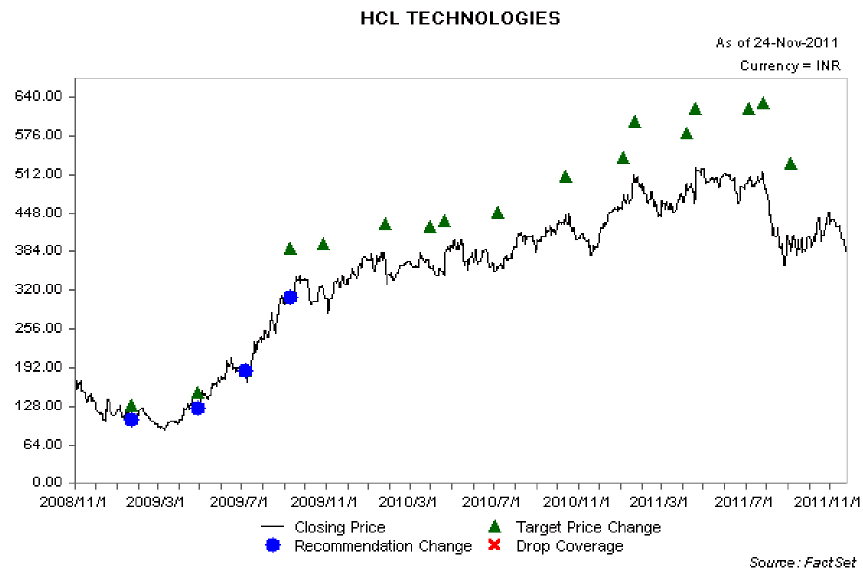
Issuer name	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
HCL Technologies	HCLT IN	INR 393	24-Nov-2011	Buy	Not rated	

Previous Rating

Issuer name	Previous Rating	Date of change
HCL Technologies	Neutral	10-Sep-2009

HCL Technologies (HCLT IN) **INR 393 (24-Nov-2011)** Buy (Sector rating: Not rated)

Rating and target price chart (three year history)



Date	Rating	Target price	Closing price
05-Sep-2011		530.00	384.15
27-Jul-2011		630.00	502.85
05-Jul-2011		620.00	506.55
20-Apr-2011		620.00	522.85
08-Apr-2011		580.00	484.35
21-Jan-2011		600.00	499.20
05-Jan-2011		540.00	471.15
13-Oct-2010		510.00	444.40
07-Jul-2010		450.00	356.00
22-Apr-2010		435.00	380.80
31-Mar-2010		425.00	357.80
26-Jan-2010		430.00	361.15
28-Oct-2009		397.00	313.50
10-Sep-2009		389.00	309.10
10-Sep-2009	Buy		309.10
06-Jul-2009		187.00	186.90
06-Jul-2009	Neutral		186.90
28-Apr-2009		152.00	125.85
28-Apr-2009	Buy		125.85
23-Jan-2009		130.00	107.00
23-Jan-2009	Reduce		107.00

For explanation of ratings refer to the stock rating keys located after chart(s)

Valuation Methodology Our target price of INR530 is based on 15x our FY13F earnings forecast of INR35.3, which is in line with its historical average valuation.

Risks that may impede the achievement of the target price The key risks are: 1) worse-than-expected slowdown and breakage of pricing discipline; 2) failure to exhibit stability in margins; 3) rupee appreciation; and 4) client-specific issues.

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