

## Revenue performance disappoints, retain HOLD

October 18, 2011

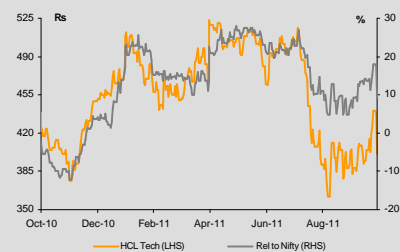
Reco	Previous Reco
Hold	Hold
CMP	Target Price
Rs401	Rs 415
EPS change FY11E/12E (%)	4/5
Target Price change (%)	6.4
Nifty	5,038
Sensex	16,748

### Price Performance

(%)	1M	3M	6M	12M
Absolute	3	(20)	(16)	(10)
Rel. to Nifty	4	(12)	(4)	8

Source: Bloomberg

### Relative Price Chart



Source: Bloomberg

### Stock Details

Sector	IT Services
Bloomberg	HCLT@IN
Equity Capital (Rs mn)	1380
Face Value(Rs)	2
No of shares o/s (mn)	690
52 Week H/L	528/360
Market Cap (Rs bn/USD mn)	277/5,620
Daily Avg Volume (No of sh)	1349190
Daily Avg Turnover (US\$m)	11.4

### Shareholding Pattern (%)

	Jun-11	Mar-11	Dec-10
Promoters	64.4	64.7	64.8
FII/NRI	23.0	23.1	23.3
Institutions	6.1	6.0	5.8
Private Corp	3.0	2.9	3.0
Public	3.5	3.4	3.1

Source: Capitaline

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- **Rev at US\$ 1002 mn (+4.1% QoQ) below est with IMS (+4.3% QoQ) after strong show over the past few qtrs. IT Svcs grew by ~4.5% QoQ while BPO's struggle continues (-2.5% QoQ)**
- **EBITDA mgns at 16.7%, down by ~130 bps QoQ (within mgmt's guided range of ~150 bps decline) aided by weak currency**
- **Op metrics performance mixed. Revenue growth led by US(+6.8% QoQ), Engg svcs(+9% QoQ) while top clients grew lower than co average for the 3<sup>rd</sup> quarter in a row**
- **Lower currency resets drive 4/5% raise in FY12/13E EPs to Rs 32.5/36.5 despite marginal cuts in revenue assumptions. Retain HOLD with a revised TP of Rs 415( V/s Rs 390 earlier)**

### Weak revenue performance leads to profit miss

HCLT reported revenues at US\$1002 mn (+4.1% QoQ, below Emkay expectations of ~5.5% growth with ~100 bps cross currency headwinds V/s expectations of ~70 bps impact). While core S/w revenues increased by ~4.5% QoQ (Seq volume growth was ~4%), IMS revenues which have seen strong growth over the past few quarters slowed down to a more sedate 4.3% QoQ growth. (BPO struggles continue with a 2.5% seq decline). EBITDA margins declined by ~130 bps QoQ aided by a weak currency despite wage increments for junior/middle level staff during the quarter. Profits at Rs 4799 mn (-2.2% QoQ, +54% YoY) missed expectation primarily on account of lower operating performance. Growth was led by US (+6.8% QoQ) amongst geographies and Manufacturing (+8% QoQ) and Retail (+20% QoQ) amongst verticals. **While client addition continued to be very good, we note that top clients have grown at lower than co average for the 3<sup>rd</sup> quarter in a row.**

### Weak currency should aid margins, however relatively inferior mining should limit SG&A leverage

In the recent quarters, HCL Tech has led peers on revenue growth with margins being the area of disappointment. While margins in Sep'11 quarter were within co's guided range of <150 bps QoQ margin decline, we believe that HCL Tech's poor client mining (relative to Tier 1 peers) should limit any substantial SG&A leverage in the medium /long term. We note that while HCL T has improved margins by ~100 bps YoY in Sep'11 quarter, the entire improvement in margins has been driven by lower SG&A proportion (down by ~100 bps YoY) and not any improvement in gross margins. In our view, HCL Tech's inferior client mining capabilities will limit any meaningful SG&A leverage in the medium /long term as HCLT needs to invest in SG&A as HCL Tech aims to keep the growth momentum going (refer section below)

### Lower currency resets drive a 4/5% raise in FY12/13E earnings. Retain HOLD

While we tweak our FY12/13 revenue estimates marginally lower, lower currency resets to Rs 48/\$ (V/s Rs 45/\$ earlier) drive a 4/5% raise in our FY12/13E earnings to Rs32.5/36.5. We retain HOLD with a revised TP of Rs 415 (V/s Rs 390 earlier)

Y/E June (in Rs mn)	Net Sales	EBITDA %	PAT	EPS (Rs)	ROE %	P/E (x)	EV/ EBITDA (x)	P/B (x)
FY10	125,650	24,813	19.7	12,149	17.6	19.1	23.0	11.3
FY11	160,343	26,512	16.5	16,221	23.4	20.7	17.3	10.4
FY12E	205,701	36,292	17.6	22,783	32.5	24.1	12.4	7.3
FY13E	235,703	38,635	16.4	25,586	36.5	22.8	11.1	6.4

## Quarterly performance

Rs mn	Q1FY11	Q2FY11	Q3 FY11	Q4 FY11	Q1 FY12	YoY (%)	QoQ (%)	YTD' 12	YTD' 11	YoY (%)
<b>Revenue</b>	<b>37,081</b>	<b>38,884</b>	<b>41,383</b>	<b>42,995</b>	<b>46,513</b>	<b>25.4</b>	<b>8.2</b>	<b>46,513</b>	<b>37,081</b>	<b>25.4</b>
<b>Operating Expenditure</b>	<b>31,294</b>	<b>32,795</b>	<b>34,475</b>	<b>35,267</b>	<b>38,750</b>	<b>23.8</b>	<b>9.9</b>	<b>38,750</b>	<b>31,294</b>	<b>23.8</b>
Cost of revenues	25,400	26,650	28,147	29,065	31,876	25.5	9.7	<b>31,876</b>	<b>25,400</b>	25.5
as % of sales	68.5	68.5	68.0	67.6	68.5			68.5	68	
SG&A expenses	5,894	6,145	6,328	6,202	6,874	16.6	10.8	<b>6,874</b>	<b>5,894</b>	16.6
as % of sales	15.9	15.8	15.3	14.4	14.8			14.8	16	
<b>EBITDA</b>	<b>5,787</b>	<b>6,090</b>	<b>6,908</b>	<b>7,728</b>	<b>7,763</b>	<b>34.2</b>	<b>0.5</b>	<b>7,763</b>	<b>5,787</b>	<b>34.2</b>
Depreciation	1,250	1,238	1,200	1,289	1,309	4.7	1.6	<b>1,309</b>	<b>1,250</b>	4.7
<b>EBIT</b>	<b>4,537</b>	<b>4,852</b>	<b>5,708</b>	<b>6,439</b>	<b>6,454</b>	<b>42.3</b>	<b>0.2</b>	<b>6,454</b>	<b>4,537</b>	<b>42.3</b>
Other Income	(650)	(80)	15	154	59	(109.1)	(61.7)	<b>59</b>	<b>(650)</b>	(109.1)
<b>PBT</b>	<b>3,887</b>	<b>4,772</b>	<b>5,723</b>	<b>6,593</b>	<b>6,513</b>	<b>67.6</b>	<b>(1.2)</b>	<b>6,513</b>	<b>3,887</b>	<b>67.6</b>
Total Tax	777	1,025	1,268	1,683	1,714	120.6	1.8	<b>1,714</b>	<b>777</b>	120.6
<b>Adjusted PAT</b>	<b>3,110</b>	<b>3,747</b>	<b>4,455</b>	<b>4,910</b>	<b>4,799</b>	<b>54.3</b>	<b>(2.2)</b>	<b>4,799</b>	<b>3,110</b>	<b>54.3</b>
(Profit)/loss from JV's/Ass/MI	-2	0	0	0	0			<b>0</b>	<b>(2)</b>	
<b>APAT after MI</b>	<b>3,108</b>	<b>3,747</b>	<b>4,455</b>	<b>4,910</b>	<b>4,799</b>	<b>54.4</b>	<b>(2.2)</b>	<b>4,799</b>	<b>3,108</b>	<b>54.4</b>
<b>Extra ordinary items</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>			<b>0</b>	<b>-</b>	
<b>Reported PAT</b>	<b>3,108</b>	<b>3,747</b>	<b>4,455</b>	<b>4,910</b>	<b>4,799</b>	<b>54.4</b>	<b>(2.2)</b>	<b>4,799</b>	<b>3,108</b>	<b>54.4</b>
<b>Reported EPS</b>	<b>4.5</b>	<b>5.4</b>	<b>6.4</b>	<b>7.0</b>	<b>6.8</b>	<b>53.0</b>	<b>(2.2)</b>	<b>7</b>	<b>4</b>	<b>53.0</b>

Margins (%)						(bps)	(bps)			
EBIDTA	15.6	15.7	16.7	18.0	16.7	108	(128)	16.7	15.6	108
EBIT	12.2	12.5	13.8	15.0	13.9	164	(110)	13.9	12.2	164
EBT	10.5	12.3	13.8	15.3	14.0	352	(133)	14.0	10.5	352
PAT	8.4	9.6	10.8	11.4	10.3	194	(110)	10.3	8.4	194
Effective Tax rate	20.0	21.5	22.2	25.5	26.3	633	79	26.3	20.0	633

Source: Company, Emkay Research

### Can lower SG&A be a sustainable margin lever for HCL Tech?

HCL Tech has been the most aggressive amongst the Tier 1 Offshore vendors on hunting new clients unlike more client farming led growth for peers TCS and Infosys (refer table below) which entail higher sales investments and thus will limit any meaningful SG&A leverage in the medium/long term in our view.

	June'09	Sep'09	Dec'09	March'10	June'10	Sep'10	Dec'10	March'11	June'11	Sep'11
Infosys	27	35	32	47	38	27	40	34	26	45
TCS	26	30	32	39	36	30	35	39	24	35
HCL Tech	37	28	36	39	51	48	46	58	70	66

Source: Companies, Emkay Research

We find clear evidence of relatively inferior client mining by HCL Tech by trying to compare HCL Tech's client metrics with Infosys when it was of similar size (Infosys had a similar quarterly revenue run rate of ~US\$ 1bn + in revenues in Sep'07 qtr). Our analysis reveals that while HCL Tech does well in terms of ramping up clients to US\$ 10 mn+/20 mn+ accounts, it is beyond that the company starts struggling. To cite, Infosys in Sep'08 had 16 US\$ 50 mn+ clients as compared to only 9 for HCL Tech.

*While HCL Tech has led peers in terms of new client additions, it has not been as successful in mining them as well...*

	Infosys( Sep'08 qtr)	HCL Tech( Sep'11 qtr)
No of US\$ 1 mn + clients	295	349
No of US\$ 5 mn + clients	122	135
No of US\$ 10mn + clients	77	79
No of US\$ 20 mn + clients	44	37
No of US\$ 30 mn + clients	30	23
No of US\$ 40 mn + clients	22	11
No of US\$ 50 mn + clients	16	9
No of US\$ 100 mn + clients	3	1
Total Number of Active clients	520	480

Source: Companies, Emkay Research

#### Changes in earnings estimates

*Lower currency resets drive a 4/5 % raise in our FY12/13E earnings to Rs 32.5/36.5 despite marginal cuts in US\$ revenue estimates*

( All fig in Rs mn except EPS)	FY12E			FY13E		
	Old	New	% change	Old	New	% change
Revenues(US\$ mn)	4,351	4,319	-0.7	4,940	4,910	-0.6
Revenues	195,782	205,701	5.1	222,278	235,703	6.0
EBITDA	34,049	36,292	6.6	36,774	38,635	5.1
Net profits	21,889	22,783	4.1	24,386	25,586	4.9
EPS	31.2	32.5	4.1	34.8	36.5	4.9

## Operating metrics performance at a glance

	Q1FY12 (% contri to revenue)	Growth	
		% QoQ	% YoY
<b><u>Service Offerings</u></b>			
Core Software	70.8%	4.5%	23.2%
BPO	4.6%	-2.5%	-3.3%
IMS	24.6%	4.3%	36.8%
<b><u>Revenue Breakup by Geography(in %)</u></b>			
US	55.8	6.8%	20.0%
Europe	26.6	2.2%	24.2%
Asia Pacific	17.5	-1.5%	42.6%
<b><u>Revenue by Service Offering( in %)</u></b>			
Enterprise App Services	19.8	-1.4%	13.8%
Engg & R&D services	18.6	8.8%	24.0%
Industry Solutions	32.4	6.0%	29.1%
Infrastructure services	24.6	4.5%	37.5%
BPO services	4.6	-2.3%	-4.4%
<b><u>Revenues by industry( in %)</u></b>			
BFSI	25.1	0.5%	24.2%
Hi Tech Manufacturing	29.0	7.8%	32.9%
Telecom	8.5	-2.8%	-3.7%
Retail	8.5	12.0%	24.7%
Media, Publishing & Entertainment	6.8	-0.3%	22.9%
Life Sciences	8	0.3%	18.7%
Others	6.6	20.5%	37.2%
Energy Utilities -Public Sector	8	0.3%	46.7%
<b><u>Client Contribution to revenues( in %)</u></b>			
Top 5, %	15.3	3.4%	7.8%
Top 10, %	24.1	2.0%	16.0%
Top 20, %	34.2	0.8%	16.5%
<b><u>Utilisation (Core Software)</u></b>			
	<b>Q1FY12</b>	<b>Q4FY11</b>	<b>Q1FY11</b>
Offshore	69.7	72.5	70.1
Offshore( excluding Trainees)	76.5	76.1	74.1
Onsite	96.0	96.2	95.7
<b><u>Total Employees</u></b>			
Gross Addition	80,520	77,046	70,218
Net Addition	9,311	9,572	11,785
	3,474	3,626	5,661
<b><u>Revenues by Contract Type( in %)</u></b>			
Time & material	56.0	57.5	58.9
Fixed Price	44.0	42.5	41.1

Amongst geographies, US led the growth with a 6.8% sequential increase

Hi Tech Manufacturing and Retail saw strong growth during the quarter

Top clients grew lower than company average for the 3<sup>rd</sup> successive quarter

## Financials

## Income Statement

Y/E, June (Rs. m)	FY10	FY11	FY12E	FY13E
<b>Net Sales</b>	125,650	160,343	205,701	235,703
Growth (%)	18	28	28	15
<b>Total Expenditure</b>	(100,837)	(133,831)	(169,409)	(197,067)
Growth (%)	21	33	27	16
<b>EBIDTA</b>	24,813	26,512	36,292	38,635
Growth (%)	11	7	37	6
<b>EBIDTA %</b>	19.7	16.5	17.6	16.4
Other Income	-	-	-	-
Depreciation	(5,010)	(4,977)	(5,701)	(6,572)
<b>EBIT</b>	<b>19,803</b>	<b>21,535</b>	<b>30,591</b>	<b>32,063</b>
Interest	-	-	-	-
<b>EBT</b>	<b>14,501</b>	<b>20,974</b>	<b>30,434</b>	<b>33,229</b>
Tax	(2,352)	(4,753)	(7,651)	(7,643)
<b>EAT</b>	<b>12,149</b>	<b>16,221</b>	<b>22,783</b>	<b>25,586</b>
Growth (%)	1	34	40	12
EAT (%)	9.7	10.1	11.1	10.9

## Cash Flow

Y/E, June (Rs. m)	FY10	FY11	FY12E	FY13E
Net Profit after Tax	12,172	16,219	22,783	25,586
Add : Depreciation	5,010	4,977	5,701	6,572
Add : Misc exp w/off	-	-	-	-
<b>Net changes in WC</b>	<b>(4,804)</b>	<b>(8,500)</b>	<b>(10,273)</b>	<b>(18,398)</b>
<b>Operational Cash Flows</b>	<b>12,974</b>	<b>15,111</b>	<b>32,244</b>	<b>38,611</b>
<b>Capital expenditure</b>	<b>(6,139)</b>	<b>(11,042)</b>	<b>(11,674)</b>	<b>(15,653)</b>
Investments	-	-	-	-
<b>Investing Cash Flows</b>	<b>(6,139)</b>	<b>(11,042)</b>	<b>(11,674)</b>	<b>(15,653)</b>
<b>Borrowings</b>	<b>(3,139)</b>	<b>(5,392)</b>	-	-
dividend paid	(3,239)	(6,095)	(6,560)	(6,560)
Issue of shares	19	4	-	-
Share Premium	-	-	-	-
<b>Financing Cash Flows</b>	<b>(6,352)</b>	<b>(11,483)</b>	<b>(6,560)</b>	<b>(6,560)</b>
changes in cash	<b>619</b>	<b>(7,414)</b>	<b>14,009</b>	<b>16,397</b>
Opening balance	<b>4,203</b>	<b>4,822</b>	<b>7,235</b>	<b>21,268</b>
<b>Closing balance</b>	<b>4,822</b>	<b>7,235</b>	<b>21,268</b>	<b>38,475</b>

## Balance Sheet

Y/E, June (Rs. m)	FY10	FY11	FY12E	FY13E
Equity share capital	1,354	1,358	1,358	1,358
Reserves & surplus	69,151	85,156	101,379	120,405
Minority Interest	(2)	-	-	-
<b>Networth</b>	<b>70,504</b>	<b>86,515</b>	<b>102,737</b>	<b>121,764</b>
Secured Loans	0	0	0	0
Unsecured Loans	26632	21240	21240	21240
<b>Loan Funds</b>	<b>26632</b>	<b>21240</b>	<b>21240</b>	<b>21240</b>
<b>Total Liabilities</b>	<b>97,136</b>	<b>107,755</b>	<b>123,977</b>	<b>143,004</b>
Goodwill	43122	41878	41878	41878
Gross Block	42,049	50,837	61,511	68,711
Less: Depreciation	23,563	28,540	34,240	40,813
<b>Net block</b>	<b>61,608</b>	<b>64,175</b>	<b>69,148</b>	<b>69,776</b>
<b>Capital WIP</b>	<b>-</b>	<b>-</b>	<b>1,000</b>	<b>1,000</b>
<b>Investment</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Current Assets</b>	<b>74,243</b>	<b>84,229</b>	<b>115,562</b>	<b>142,961</b>
Sundry debtors	30,496	34,065	42,831	48,432
Cash & bank balance	4,822	7,235	21,268	38,475
Loans & advances	9,640	10,392	16,045	18,385
<b>Current Liab &amp; Prov</b>	<b>38,715</b>	<b>40,650</b>	<b>61,710</b>	<b>70,711</b>
Current liabilities	31,329	33,763	49,368	56,569
Provisions	7,386	6,887	12,342	14,142
<b>Net current assets</b>	<b>35,528</b>	<b>43,579</b>	<b>53,852</b>	<b>72,250</b>
<b>Total Assets</b>	<b>97,136</b>	<b>107,754</b>	<b>123,977</b>	<b>143,003</b>

## Key Ratios

Y/E, June	FY10	FY11	FY12E	FY13E
EPS (Rs)	17.6	23.4	32.5	36.5
CEPS (Rs)	24.8	30.5	40.6	45.9
Book Value Per Share (Rs)	101.9	124.6	146.6	173.7
Dividend Per Share (Rs)	4.0	7.5	8.0	8.0
<b>Valuations Ratios (x)</b>				
PER	23.0	17.3	12.4	11.1
P/CEPS	16.3	13.3	10.0	8.8
P/BV	4.0	3.2	2.8	2.3
EV/EBIDTA	11.3	10.4	7.3	6.4
EV/Sales	2.2	1.7	1.3	1.0
M-Cap/sales	2.2	1.8	1.4	1.2
<b>Profitability Ratios (%)</b>				
RoCE	21.6	21.0	26.4	24.0
RoNW	19.1	20.7	24.1	22.8
EBITDA Margin	19.7	16.5	17.6	16.4
EBIT Margins	15.8	13.4	14.9	13.6
Net Profit Margin	9.7	10.1	11.1	10.9

**Recommendation History: HCL Technologies – HCLT IN**

Date	Reports	Reco	CMP	Target
28/07/2011	<a href="#">HCL Technologies Q4FY11 Result Update</a>	Hold	503	540
20/04/2011	<a href="#">HCL Technologies Q3FY11 Result Update</a>	Hold	523	540
20/01/2011	<a href="#">HCL Technologies Q2FY11 Result Update</a>	Hold	508	540
20/10/2010	<a href="#">HCL Technologies Q1FY11 Result Update</a>	Hold	426	430

**Recent Research Reports**

Date	Reports	Reco	CMP	Target
18/10/2011	<a href="#">TCS Q2FY12 Result Update</a>	Hold	1,120	1,060
18/10/2011	<a href="#">Mindtree Q2FY12 Result Update</a>	Accumulate	386	450
18/10/2011	<a href="#">Persistent Q2FY12 Result Update</a>	Hold	323	330
12/10/2011	<a href="#">Infosys Q2FY12 Result Update</a>	Accumulate	2,681	2,800

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