

HCL Technologies

Performance Highlights

(` cr) – Consol.	3QFY19	2QFY19	% chg (qoq)	3QFY18	% chg (yoy)
Net revenue	15,699	14,861	5.6	12,808	22.6
EBIT	3,086	2,966	4.0	2,509	23.0
EBIT margin (%)	19.7	20.0	(30)bps	19.6	7bps
PAT	2,611	2,540	2.8	2,194	19.0

Source: Company, Angel Research

HCL Tech on sales front posted 4.9% sequential growth in USD revenues to US\$2,202mn v/s. US\$2,099mn in 2QFY2019. In Constant currency terms (CC), the company posted a 5.6% qoq growth. EBIT margin came in at 19.7% v/s 20.0% in 2QFY2019. Consequently, PAT came in at `2,611cr v/s. `2,540cr in 2QFY2019, a rise of 2.8% qoq. FY2019 revenue guidance is kept at the mid-range of 9.5-11.5% in CC, while operating margin are expected to be in the range of 19.5-20.5%. **We recommend a Reduce; given that the company is too dependent on the acquisition as a strategy to grow higher than Industry. This will keep a check on its business ROIC & hence multiples.**

Quarterly highlights: HCL Tech on sales front posted 4.9% sequential growth in USD revenues to US\$2,202mn V/s. US\$2,099mn in 2QFY2019. In Constant currency terms (CC), the company posted a 5.6% qoq growth. EBIT margin came in at 19.7% v/s 20.0% in 2QFY2019. Consequently, PAT came in at `2,611cr V/s. `2,540cr in 2QFY2019, a rise of 2.8% qoq. Industry segment wise, the company's Financial Services vertical posted a 0.6% qoq de-growth in CC terms. The Manufacturing vertical (contributing 17.7% to revenue) posted a 3.9% qoq growth in CC terms. Consequently, PAT came in at `2,611cr V/s. `2,540cr in 2QFY2019, a rise of 2.8% qoq.

Outlook and valuation: We expect HCL Tech to post a USD and INR revenue CAGR of 11.6% and 15.2% respectively over FY2018–21E. The growth will be aided by the acquisitions. However, given its profitability & valuations & given the backdrop that it is concentrated on few services; **we recommend a Reduce stance.**

Key financials (Consolidated, US GAAP)

Y/E March (` cr)	FY2018	FY2019E	FY2020E	FY2021E
Net sales	50,570	60,937	68,853	77,255
% chg	8.2	20.5	13.0	12.2
Net profit	8,781	10,150	11,229	12,575
% chg	3.8	15.6	10.6	12.0
EBITDA margin (%)	22.6	22.9	23.9	23.9
EPS (`)	62.3	72.0	79.6	89.2
P/E (x)	16.6	14.4	13.0	11.6
P/BV (x)	4.0	3.6	3.2	2.9
RoE (%)	23.9	24.7	24.6	24.7
RoCE (%)	20.6	22.0	21.3	21.7
EV/Sales (x)	2.6	2.1	1.9	1.6
EV/EBITDA (x)	11.4	9.0	8.0	6.7

Source: Company, Angel Research; Note: CMP as of February 1, 2019

REDUCE

CMP `1034

Target Price `900

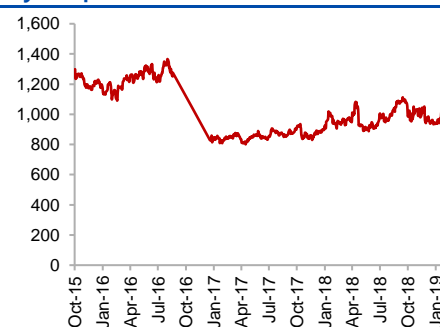
Investment Period 12 Months

Stock Info	
Sector	IT
Market Cap (` cr)	139,987
Net Debt (` cr)	(12140)
Beta	0.4
52 Week High / Low	1125/880
Avg. Daily Volume	87,836
Face Value (`)	2
BSE Sensex	36,257
Nifty	110,831
Reuters Code	HCLT.BO
Bloomberg Code	HCLT@IN

Shareholding Pattern (%)	
Promoters	60.1
MF / Banks / Indian FIs	8.2
FII / NRIs / OCBs	28.3
Indian Public / Others	3.5

Abs. (%)	3m	1yr	3yr
Sensex	7.0	0.8	46.1
HCL Tech	0.1	2.0	14.4

3-year price chart



Source: Company, Angel Research

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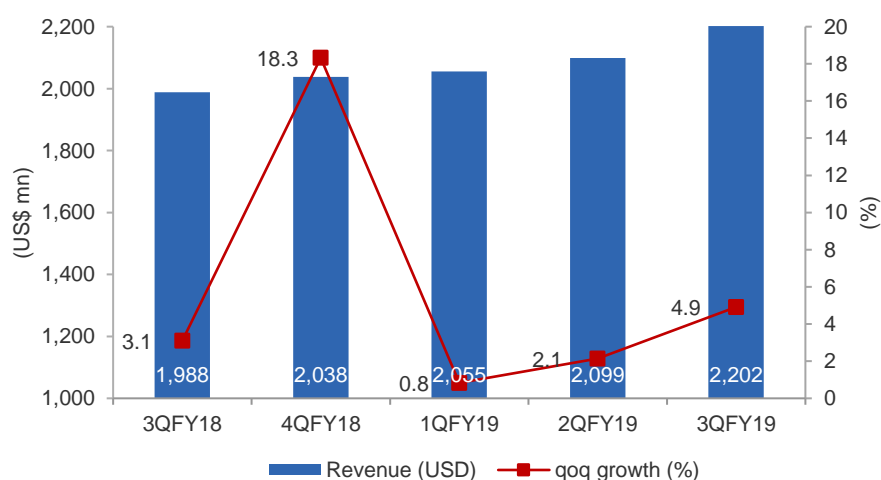
Exhibit 1: 3QFY2019 performance (Consolidated, US GAAP)

Y/E March (₹ cr)	3QFY19	2QFY19	% chg (qoq)	3QFY18	% chg (yoy)	9MFY19	9MFY18	% chg(yoy)
Net revenue	15,699	14,861	5.6	12,808	22.6	44,437	37,391	18.8
Cost of revenue	10,152	9,589	5.9	8,412	20.7	22,781	19,329	17.9
Gross profit	5,547	5,272	5.2	4,396	26.2	21,656	18,062	19.9
SG&A expense	1,900	1,773	7.2	1,432	32.7	11,324	9,838	15.1
EBITDA	3,647	3,499	4.2	2,964	23.0	10,332	8,224	25.6
Dep. and amortization	561	533	5.3	455	23.3	1,528	954	60.2
EBIT	3,086	2,966	4.0	2,509	23.0	8,804	7,270	21.1
Other income	105	252	(58.3)	264	(60.2)	638	878	(27.3)
PBT	3,191	3,218	(0.8)	2,773	15.1	9,442	8,148	15.9
Income tax	566	678	(16.5)	579	(2.2)	1,872	1,656	13.0
PAT	2,625	2,540	3.3	2,194	19.6	7,570	6,492	16.6
Forex gain/(loss)	14	-	-	-	-	-	1	-
Adjusted PAT	2,611	2,540	2.8	2,194	19.0	7,570	6,493	16.6
EPS	19.3	18.2	5.7	15.8	22.2	55.8	46.6	19.7
Gross margin (%)	35.3	35.5	(14)bps	34.3	101bps	48.7	48.3	43bps
EBITDA margin (%)	23.2	23.5	(31)bps	23.1	9bps	23.3	22.0	126bps
EBIT margin (%)	19.7	20.0	(30)bps	19.6	7bps	19.8	19.4	37bps
PAT margin (%)	16.6	17.1	(46)bps	17.1	(50)bps	17.0	17.4	(33)bps

Source: Company, Angel Research

Robust Sales growth

HCL Tech on sales front posted 4.9% sequential growth in USD revenues to US\$2,202mn v/s. US\$2,099mn in 2QFY2019. In Constant currency terms (CC), the company posted a 5.6% qoq growth. Industry segment wise, the company's Financial Services vertical posted a 0.6% qoq de-growth in CC terms. The Manufacturing vertical (contributing 17.7% to revenue) posted a 3.9% qoq growth in CC terms.

Exhibit 2: Revenue growth trend


Source: Company, Angel Research

In terms of services, Engineering & R&D services (which constituted 25.5% of sales) posted a growth of 5.1% qoq (CC), while Application services (accounting for 32.0% of sales) grew by 2.3% qoq (CC). Infrastructure services, another important segment of the company, which contributes around 37.5% to overall sales, posted growth of 10.4% qoq (CC). Business services, which constituted 5.0% of sales, de-grew by 5.1% qoq (CC).

Exhibit 3: Revenue growth trend (Service wise)

	% of revenue	% growth CC (qoq)	% growth (yoy)
Application services	32.0	2.3	2.5
Infrastructure services	37.5	10.4	16.5
Business services	5.0	(3.7)	50.1
Engineering and R&D services	25.5	5.1	17.4

Source: Company, Angel Research

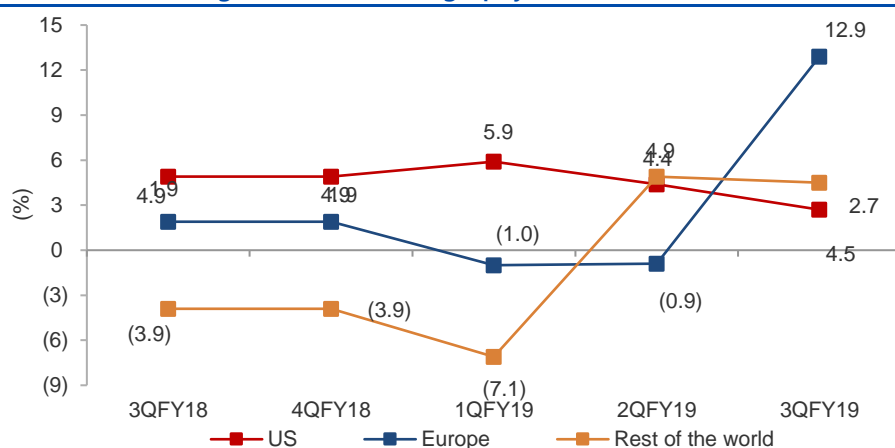
Industry segment wise, the company's Financial Services vertical (contributing 21.6% to revenue) posted a 0.6% qoq de-growth in CC terms. The Manufacturing vertical (contributing 17.7% to revenue) posted a 3.9% qoq growth in CC terms. Public services, Life Sciences & Healthcare, and Telecommunication, Media, Publishing & Entertainment reported a qoq growth of (4.4) %, 5.8% and 35.4% respectively, all in CC terms. Retail & CPG (contributing 10.2% of the revenue), on the other hand, reported growth of 8.4% qoq in CC terms during the quarter.

Exhibit 4: Revenue growth trend (Industry wise)

	% of revenue	% growth (CC qoq)	% growth (yoy)
Financial services	21.6	(0.6)	0.1
Manufacturing	17.7	3.9	1.5
Life sciences & Healthcare	13.0	5.8	23.4
Public Services	9.7	(4.4)	8.1
Retail & CPG	10.2	8.4	21.5
Telecom, MPE	9.2	35.4	40.3
Technology & Services	18.7	7.5	24.4

Source: Company, Angel Research

Among geographies, in CC terms, America grew by 2.7% qoq; RoW grew by 4.5% qoq, while Europe grew by 12.9% qoq, during the period.

Exhibit 5: Revenue growth trend (Geography wise in CC terms)


Source: Company, Angel Research

Hiring and utilization

During the quarter, the overall headcount of HCL Tech increased by 13,191 to 1,32,328 employees. The attrition rate in IT Services inched upwards to 17.8% (v/s. 17.1% in 2QFY2019) and the blended utilization level of the company remained stagnant at 86.6% (86.7% in 2QFY2019).

Exhibit 6: Hiring trend

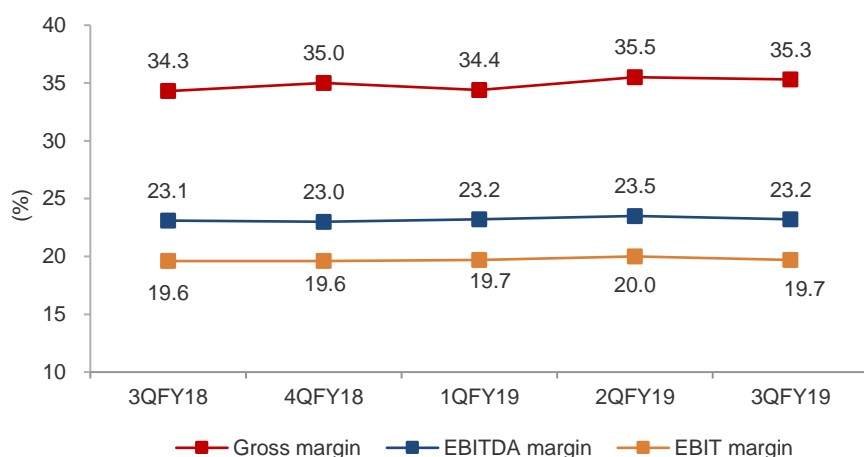
Particulars	3QFY18	4QFY18	1QFY19	2QFY19	3QFY19
Technical	1,08,831	1,09,565	1,13,404	1,16,910	1,21,273
Support	10,460	10,516	10,717	10,965	11,055
Total employee base	1,19,291	1,20,081	1,24,121	1,27,875	1,32,328
Gross addition	7,113	8,476	12,558	11,683	13,191
Net addition	251	790	4,040	3,754	4,453
Attrition - IT services (LTM) - %	15.2	15.5	16.3	17.1	17.8

Source: Company, Angel Research

Operating margin shrink

On the operating front, the EBDITA margins came in at 23.2% (v/s. 23.5% in 2QFY2019), a qoq dip of 31bps, while the EBIT margins came in at 19.7%, a qoq dip of 30bps. The negative impact of wage hikes was partly offset by higher utilization and currency benefits.

Exhibit 7: Margin profile



Source: Company, Angel Research

Client pyramid

The company signed 17 transformational deals this quarter. These deals represented a well-balanced mix across service lines, industry verticals and geographies. Company added US\$5+ mn clients up by 15, US\$10+ mn clients up by 8, US\$50+ mn clients up by 4 and US\$100+ mn clients up by 1.

Investment arguments

Guidance re-iterated for FY2019: On the basis of deals on hand, the company maintained to meet its revenue growth guidance of 9.5-11.5% in CC terms (striving to achieve a mid-point of the guidance) for FY2019, which includes a component of inorganic growth, adjusting for which, the organic growth would be in the range of 6.0-6.5% in CC for FY2019. The operating margin (EBIT) for FY2019 is expected to be in the range of 19.5-20.5%. We expect HCL Tech to post a USD and INR revenue CAGR of 11.6% and 15.2% respectively, over FY2018–21E.

IBM – Deal will mark its foray into enterprise product space: HCL Tech during the quarter acquired 7 products from IBM for US\$1.8bn. The products span across areas such as Application Security, Endpoint Management, Low Code, Digital Commerce and Experience, and Marketing Automation. The deal will close in 6 months and mostly funded through the internal accrual & debt of US\$300mn. Approximately 48% to be paid at close, most of balance to be paid after one year of acquisition. The deal is likely to bring in incremental revenue of ~US\$650mn on a run-rate basis in second year after close. On operating front, EBITDA margins are expected to be over 50% on a run-rate basis (slightly lower in year one of acquisition), while Cash EPS accretion of ~15% is expected. With this, the product contribution to the sales will increase from 11.9% in 9MFY2019 to 17%. The deal seems though seems fairly valued on PE basis; but given high that the portfolio will have a little growth; given mature nature of products, we find the deal expensive on EV/ sales basis at around 2.7x.

Healthy pipeline: HCL Tech signed 17 transformational deals this quarter, across service lines and industry verticals. The broad-based business wins were driven by next-generation integrated offerings – Next-Gen ITO, BEYONDigital, and IoT WoRKS, reflecting investments in Internet of Things, digital technologies, cloud, automation and artificial intelligence. These deals represented a well-balanced mix across service lines, industry verticals and geographies. Company added US\$5+ mn clients up by 15, US\$10+ mn clients up by 8, US\$50+ mn clients up by 4 and US\$100+ mn clients up by 1.

Outlook & Valuation

We expect HCL Tech to post a USD and INR revenue CAGR of 11.6% and 15.2% respectively over FY2018–21E. The growth will be aided by the acquisitions. However, given its profitability & valuations & given the backdrop that it is concentrated on few services; **we recommend a Reduce stance.**

Company Background

HCL Tech is India's fifth largest IT services company, with over 1,30,000 employees catering to more than 600 clients. The company's service offerings include Enterprise Application Services (EAS), Custom Applications, Engineering Research & Development (ERD), and Infrastructure Management Services (IMS). In December 2008, HCL Tech acquired UK-based SAP consulting company – Axon. During 3QFY2016, the company acquired Geometric Software. In 3QFY2019, it acquired seven products from IBM for US\$1.8bn.

Profit and loss statement (Consolidated, US GAAP)

Y/E Mar (₹ cr)	FY2017	FY2018	FY2019E	FY2020E	FY2021E
Net sales	46,723	50,570	60,937	68,853	77,255
Cost of revenues	30,890	33,237	39,852	43,928	49,288
Gross profit	15,833	17,333	21,084	24,925	27,966
% of net sales	33.9	34.3	34.6	36.2	36.2
SG&A expenses	5,524	5,894	7,130	8,469	9,502
% of net sales	11.8	11.7	11.7	12.3	12.3
EBITDA	10,309	11,439	13,954	16,456	18,464
% of net sales	22.1	22.6	22.9	23.9	23.9
Depreciation and amort.	835	1,453	1,767	2,920	3,245
% of net sales	1.8	2.9	2.9	4.2	4.2
EBIT	9,474	9,986	12,187	13,536	15,219
% of net sales	20.3	19.7	20.0	19.7	19.7
Other income, net	934	1,111	500	500	500
Profit before tax	10,408	11,097	12,687	14,036	15,719
Provision for tax	1,952	2,316	2,537	2,807	3,144
% of PBT	18.8	20.9	20.0	20.0	20.0
PAT	8,457	8,781	10,150	11,229	12,575
Fully diluted EPS (₹)	60.0	62.3	72.0	79.6	89.2

Balance sheet (Consolidated, US GAAP)

Y/E Mar (' cr)	FY2017	FY2018	FY2019E	FY2020E	FY2021E
Cash and cash equivalent	1,317	1,694	574	1,437	2,733
Account receivables, net	8,301	9,639	11,615	13,123	14,725
Unbilled receivables	2,501	2,618	3,169	3,580	4,017
Deposit with banks	10,220	5,727	10,806	11,056	11,036
Deposit (one year with HDFC Ltd)	-	-	-	-	-
Invest. securities, available for sale	1,146	2,357	2,251	255	3,435
Other current assets	2,983	2,520	2,825	3,125	3,126
Total current assets	26,468	24,555	31,240	32,577	39,072
Property and equipment, net	4,681	5,185	5,485	5,785	6,085
Intangible assets, net	11,426	14,406	14,406	20,775	20,775
Deposits with HDFC Ltd.	-	-	-	-	-
Fixed deposits with banks	-	-	-	-	-
Investment securities HTM	147	27	27	27	48
Investment in equity investee	-	-	-	-	-
Other assets	3,712	4,263	4,263	4,263	4,263
Total assets	46,432	48,435	55,420	63,426	70,243
Current liabilities	11,148	9,914	11,876	13,091	14,688
Borrowings	542	437	437	2,567	2,567
Other liabilities	1,253	1,267	2,078	2,079	2,080
Total liabilities	12,942	11,618	14,391	17,737	19,335
Minority interest	-	-	-	-	-
Total stockholder equity	33,490	36,817	41,029	45,689	50,908
Total liab. and stock holder equity	46,432	48,435	55,420	63,426	70,243

Cash flow statement (Consolidated, US GAAP)

Y/E Mar (` cr)	FY2017	FY2018	FY2019E	FY2020E	FY2021E
Pre tax profit from operations	8,457	8,781	10,150	11,229	12,575
Depreciation	835	1,453	1,767	2,920	3,245
Expenses (deferred)/written off/others	(48)	(48)	(48)	(48)	(48)
Pre tax cash from operations	9,244	10,186	11,869	14,101	15,772
Other income/prior period ad	934	1,111	500	500	500
Net cash from operations	10,178	11,297	12,369	14,601	16,272
Tax	(1,952)	(2,316)	(2,537)	(2,807)	(3,144)
Cash profits	8,226	8,981	9,832	11,793	13,128
(Inc)/dec in current assets	(653)	(992)	(2,831)	(2,220)	(2,039)
Inc/(dec) in current liabilities	1,639	(1,233)	1,962	1,215	1,597
Net trade working capital	987	(2,225)	(869)	(1,006)	(442)
Cashflow from operating activities	9,213	6,756	8,963	10,787	12,686
(Inc)/dec in fixed assets	(358)	(504)	(300)	(300)	(300)
(Inc)/dec in intangibles	(5,006)	(2,980)	-	(6,369)	-
(Inc)/dec in investments	(242)	3,282	(4,974)	1,746	(3,160)
(Inc)/dec in minority interest	-	-	-	-	-
Inc/(dec) in non current liabilities	(11)	-	-	-	-
(Inc)/dec in non current assets	(573)	463	(305)	(300)	(1)
Cashflow from investing activities	(6,189)	260	(5,579)	(5,223)	(3,461)
Inc/(dec) in debt	-	-	-	-	-
Inc/(dec) in equity/premium	-	-	-	-	-
ESOP charges	(103)	(103)	(103)	(103)	(103)
Dividends	(3,960)	(1,980)	(5,938)	(6,569)	(7,357)
Others	1,769	(3,617)	4,350	1,681	(329)
Cashflow from financing activities	(2,294)	(5,700)	(1,690)	(4,991)	(7,788)
Cash generated/(utilised)	587	377	(1,120)	863	1,296
Cash at start of the year	729	1,317	1,694	574	1,437
Cash at end of the year	1,317	1,694	574	1,437	2,733

Key ratios

Y/E Mar	FY2017	FY2018	FY2019E	FY2020E	FY2021E
Valuation ratio (x)					
P/E (on FDEPS)	17.2	16.6	14.4	13.0	11.6
P/CEPS	15.7	14.3	12.2	10.3	9.2
P/BVPS	4.4	4.0	3.6	3.2	2.9
Dividend yield (%)	2.3	1.2	3.5	3.8	4.3
EV/Sales	2.7	2.6	2.1	1.9	1.6
EV/EBITDA	12.4	11.4	9.0	8.0	6.7
EV/Total assets	2.8	2.7	2.3	2.1	1.8
Per share data (₹)					
EPS (Fully diluted)	60.0	62.3	72.0	79.6	89.2
Cash EPS	65.9	72.6	84.5	100.3	112.2
Dividend	24.0	12.0	36.0	39.8	44.6
Book value	237	261	291	324	361
Dupont analysis					
Tax retention ratio (PAT/PBT)	0.8	0.8	0.8	0.8	0.8
Cost of debt (PBT/EBIT)	1.1	1.1	1.0	1.0	1.0
EBIT margin (EBIT/Sales)	0.2	0.2	0.2	0.2	0.2
Asset turnover ratio (Sales/Assets)	1.0	1.0	1.1	1.1	1.1
Leverage ratio (Assets/Equity)	1.4	1.3	1.4	1.4	1.4
Operating ROE	25.3	23.9	24.7	24.6	24.7
Return ratios (%)					
RoCE (pre-tax)	20.4	20.6	22.0	21.3	21.7
Angel RoIC	28.2	25.8	29.2	26.7	28.7
RoE	25.3	23.9	24.7	24.6	24.7
Turnover ratios (x)					
Asset turnover (fixed assets)	10.4	10.3	11.4	12.2	13.0
Receivables days	78	72	76	74	74

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2. Ownership of 1% or more of the stock by research analyst or Angel or associates or relatives	No
3. Served as an officer, director or employee of the company covered under Research	No
4. Broking relationship with company covered under Research	No

Ratings (Based on expected returns over 12 months investment period):

Buy (> 15%)

*Accumulate (5% to 15%)
Reduce (-5% to -15%)*

*Neutral (-5 to 5%)
Sell (< -15)*