

# HCL Technologies

**BUY**

## Q1FY18 – Another quarter of EBIT margin surprise

### Summary

- Q1FY18 revenue growth of 2.6% QoQ in CC was slightly lower than our forecast of +2.8%. However, EBIT margin of 20.1% beat our forecast of 19.8%. Further, higher FX gain aided EPS of Rs15.2, -7.6%/+5.1% QoQ/YoY which was also a beat.
- HCLT has maintained its FY18 guidance - CC revenue growth guidance of 10.5%-12.5% and EBIT margin of 19.5%-20.5%, in-line with our expectation.
- We largely maintain our FY18/19 revenue (US\$)/EPS forecast which factors CAGR of 12.1%/11.3%. Our TP of 1,038 (from Rs1,027) is based on 14x FY19E. HCLT continues to be our only BUY along with Infosys (INFO) amongst IT large-caps.

### Key Highlights and Investment Rationale

- IP-partnership with IBM strengthened; Investment in IP to continue**  
 HCLT has extended its partnership with IBM covering areas of Marketing Automation, zSystems Software Portfolio & Operating Tools and Application Modernization. It will invest US\$140mn for the same and expects revenue of US\$30-35mn in the first year. This deal would start contributing to revenue in H2FY18.  
 HCLT has re-iterated its focus for driving strong growth in its Mode 3 solutions (products/platforms) and would continue to invest in IP-partnerships with IBM and other tech companies. It currently does not have a cap on such investments.
- Q1FY18 result – an over-all beat to our forecast**  
 While the revenue growth of 2.6% QoQ was slightly (~20 bps) lower than our forecast, the 3.7% growth in US\$ was in-line. HCLT was able to offset the headwind of INR appreciation through better sales mix and operational efficiencies. This enabled it to report a QoQ improvement in EBIT margin vs. our forecast of a decline of 24bps.
- HCLT continues to remain our high conviction BUY**  
 Our target PER of 14x on FY19E is in-line with median 1year forward PER of 13.5x in the last 3 years and is at the mid-point of the PER band of 12x-17x. M&A remains an upside trigger to our forecast.

<b>TP</b>	<b>Rs1,038</b>
<b>CMP</b>	<b>Rs890</b>
Potential upside / downside	+17%
Previous Rating	BUY

### V/s Consensus

EPS (Rs)	FY18E	FY19E
IDBI Capital	66.6	74.1
Consensus	61.5	67.4
% difference	8.3	9.9

### Shareholding Pattern (%)

Promoters	59.7
FII	25.3
DII	10.5
Public	4.6

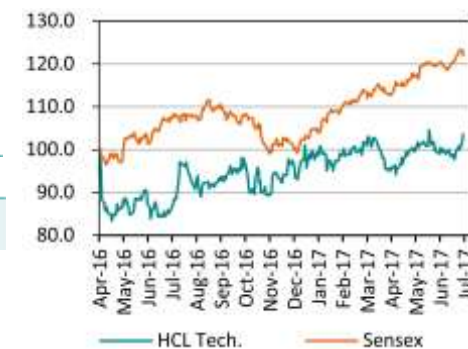
### Price Performance (%)

	-1m	-3m	-12m
Absolute	5.1	11.7	20.1
Rel to Sensex	2.5	5.7	5.9

### Key Stock Data

Bloomberg / Reuters	HCLT IN / HCLT.BO
Sector	IT Services
Shares o/s (mn)	1,378
Market cap. (Rsmn)	1,276,441
Market cap. (US\$ mn)	19,842
3-m daily average value (Rsmn)	895
52-week high / low	Rs910 / 731
Nifty / Sensex	10,021 / 32,383

### Relative to Sensex (%)



### Financial snapshot

Year	FY2015	FY2016	FY2017	FY2018E	FY2019E
Revenue	370,620	311,360	467,220	518,021	587,104
EBITDA	87,020	66,958	103,090	116,202	131,402
EBITDA (%)	23.5	21.5	22.1	22.4	22.4
Adj. PAT	72,531	50,282	84,570	91,738	102,151
EPS (Rs)	51.6	35.7	59.8	66.6	74.1
EPS Growth (%)	13.4	(30.9)	67.8	11.2	11.4
PE (x)	16.6	24.0	14.3	12.8	11.5
Dividend Yield (%)	2.0	2.0	2.8	0.9	3.2
EV/EBITDA (x)	12.6	16.7	10.5	9.0	7.6
RoE (%)	33.1	19.5	28.0	26.0	25.3
RoCE (%)	36.7	23.4	30.1	28.8	28.6

Source: Company; IDBI Capital Research

## Key highlights from the earnings con-call

- **Renewals in Q1FY18** – HCLT confirmed that it has been able to renew all the details that came up for renewal in Q1FY18. In fact, for most of them it has been able to secure enhancement in the deal.
- **Deal pipeline**–HCLT confirmed that deal pipeline continues to remain healthy and is better YoY. It continues to build skills/competencies to drive growth in Next-Gen services (Digital & Analytics, IoT, Cloud, Cyber-security)
- **IMS vertical (38.6% of revenue) – cautious outlook for the near term, no structural change**–HCLT has given a cautious outlook for the IMS vertical mainly on account of:
  - Slowdown in the decision making for large deals, especially in the US
  - FY16/17 saw HCLT securing large deals which have entered the second year resulting in reduced scope of work in line with the nature of such deals

HCLT is targeting to offset the impact of the same by pursuing aggressive growth in new markets. It expects FY18 to see relatively slower growth compared to previous years. However, it is confident that there is no structural change and expects IMS to remain a high growth vertical in the long-term. It is optimistic of IMS returning to strong growth path towards the end of FY18.

- **Financial Services (24.9% of revenue) has seen a relatively stronger growth for HCLT vs. peers** –HCLT has seen the benefit of significant account wins from Fortune 500 companies in the US and Europe in the previous quarters. HCLT has geared itself to cater to the digital scale (front-end to back-end) requirement of its clients and has re-aligned its go-to-market with significantly higher share of Mode 2 solutions (Next-Gen services). It also confirmed that the worst as regards the impact of in-sourcing is behind.
- **Focus on aggressive growth in Mode 2 (Next-Gen services) and Mode 3 (Products/Platforms) solutions to continue**–HCLT re-iterated that it has been able to take a great stride forward in its Mode 2 solutions. As regards Mode 3 services, it would continue to invest in IPs which includes that in partnership with tech majors like IBM.
- **M&A continues to remain a key focus area**–HCLT's focus area for M&A continues to remain – 1) IP, 2) Mode 2 solutions and 3) New geographies for Mode 1 solutions (traditional IT services - Applications, Infrastructure, BPO and Engineering & R&D).

**Table 1: Financial snapshot**
**(Rs mn)**

Year-end: March	Q1FY18	Q4FY17	QoQ (%)	Q1FY17	YoY (%)
<b>Revenues (US\$ mn)</b>	<b>1,884</b>	<b>1,817</b>	<b>3.7</b>	<b>1,691</b>	<b>11.4</b>
<b>Revenues</b>	<b>121,490</b>	<b>120,530</b>	<b>0.8</b>	<b>113,360</b>	<b>7.2</b>
COGS	80,570	79,870	0.9	74,400	8.3
Gross profit	40,920	40,660	0.6	38,960	5.0
SG&A	14,110	14,170	(0.4)	13,750	2.6
<b>EBITDA</b>	<b>26,810</b>	<b>26,490</b>	<b>1.2</b>	<b>25,210</b>	<b>6.3</b>
Depreciation & amortization	2,360	2,330	1.3	1,880	25.5
<b>EBIT</b>	<b>24,450</b>	<b>24,160</b>	<b>1.2</b>	<b>23,330</b>	<b>4.8</b>
Other income	2,690	2,150	25.1	2,530	n.m.
PBT	27,140	26,310	3.2	25,860	4.9
Tax	5,420	3,030	78.9	5,430	(0.2)
Adjusted net profit	21,720	23,280	(6.7)	20,430	6.3
<b>Reported net profit</b>	<b>21,720</b>	<b>23,280</b>	<b>(6.7)</b>	<b>20,430</b>	<b>6.3</b>
<b>Diluted EPS (Rs)</b>	<b>15.2</b>	<b>16.5</b>	<b>(7.6)</b>	<b>14.5</b>	<b>5.1</b>
<b>As % of net revenue</b>					
Gross profit	33.7	33.7		34.4	
SG&A	11.6	11.8		12.1	
EBITDA	22.1	22.0		22.2	
EBIT	20.1	20.0		20.6	
Reported net profit	17.9	19.3		18.0	
Tax rate	20.0	11.5		21.0	

Source: Company; IDBI Capital Research

While CC revenue growth of 2.6% QoQ was slightly lower than our forecast, the US\$ growth of 3.7% was in-line.

EBIT margin improved by 8bps QoQ to 20.1% despite the headwind of INR appreciation and was higher than our forecast of 19.8%. HCLT was able to offset the headwind through improvement in revenue mix and operational efficiencies.

Higher FX gain aided EPS further beating our forecast.

**Table 2: Actual vs. estimates**

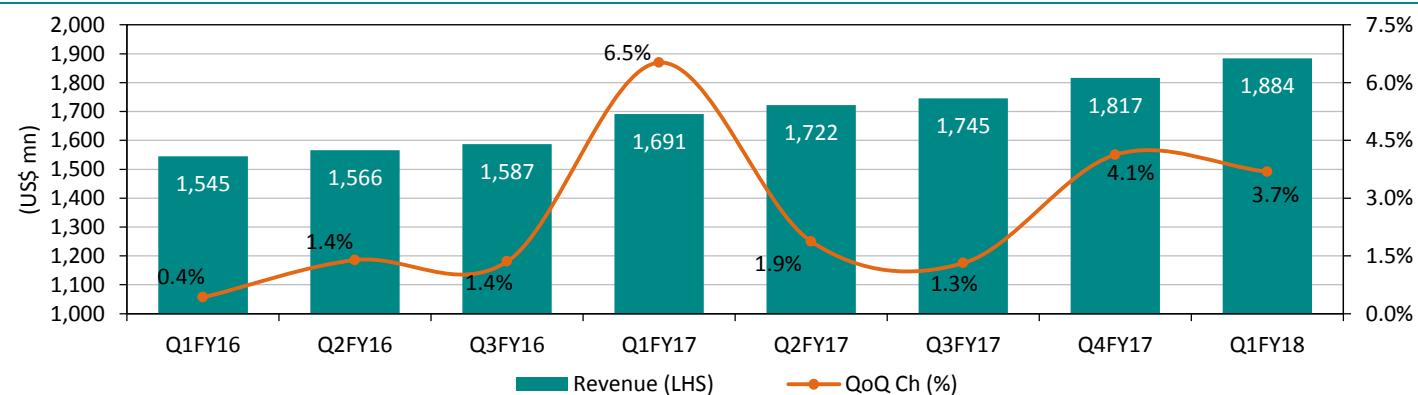
Year to March	Q1FY18	Q1FY18E	Variance (%)
Revenue (US\$ mn)	1,884	1,882	0.1
Revenue (Rs mn)	121,490	121,324	0.1
EBIT (Rs mn)	24,450	24,025	1.8
EBIT margin (%)	20.1	19.8%	32bps
PAT (Rs mn)	21,720	20,555	5.7
PAT margin (%)	17.9	16.9	94bps
EPS (Rs)	15.2	14.5	4.7

Source: Company; IDBI Capital Research

**Table 3: Earnings Revision**

Year-end: March	FY18F		Chg (%)	FY19F		Chg (%)
	New	Old		New	Old	
Revenue (US\$ mn)	7,847	7,829	0.2	8,763	8,732	0.4
Revenue (Rs bn)	518.0	528.5	(2.0)	587.1	589.4	(0.4)
EPS (Rs/sh)	66.6	66.1	0.7	74.1	73.0	1.5

Source: Company; IDBI Capital Research

**Figure 1: Q1FY18 revenue in US\$ was in-line with our forecast**


Source: Company; IDBI Capital Research

**Table 4: Revenue growth across various segments**

(%)

Parameters	CC growth
Overall revenue growth	2.6
Geography	CCgrowth
<b>US</b>	<b>3.8</b>
Europe	(0.4)
ROW	3.1
Service-lines	CCgrowth
Application Services	1.6
<b>Engineering and R&amp;D Services</b>	<b>7.9</b>
Infrastructure Services	1.7
Business Services	(6.7)
Verticals	CC growth
<b>Financial Services</b>	<b>5.3</b>
Manufacturing	3.3
Telecom & Media Publishing & Entertainment	(2.5)
Retail & CPG	4.9
Life science & Healthcare	4.8
Public Sector	(2.7)

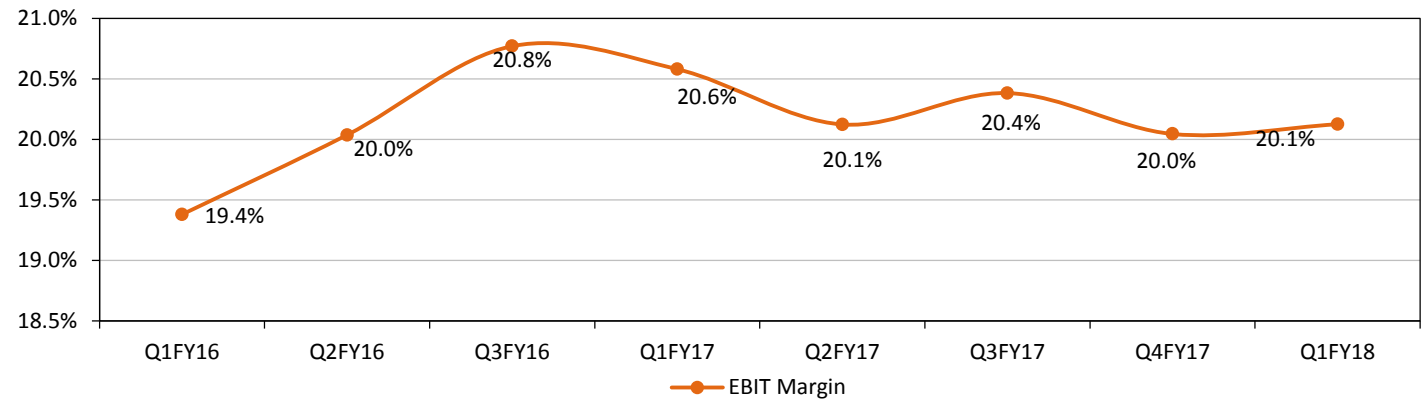
Source: Company; IDBI Capital Research

**Table 5: Growth in large clients continues to remain healthy**

Year-end: March	Q1FY16	Q2FY16	Q3FY16	Q1FY17	Q2FY17	Q3FY17	Q4FY17	Q1FY18
US\$100m +	7	7	8	7	8	8	8	8
US\$50m +	18	19	19	20	20	24	25	25
US\$40m +	24	26	29	32	34	35	34	35
US\$30m +	43	42	43	48	49	48	49	52
US\$20m +	75	74	75	80	82	87	85	86
US\$10m +	133	140	144	146	146	148	153	154
US\$5m +	224	227	233	237	235	241	246	249
US\$1m +	486	494	482	482	494	496	506	508

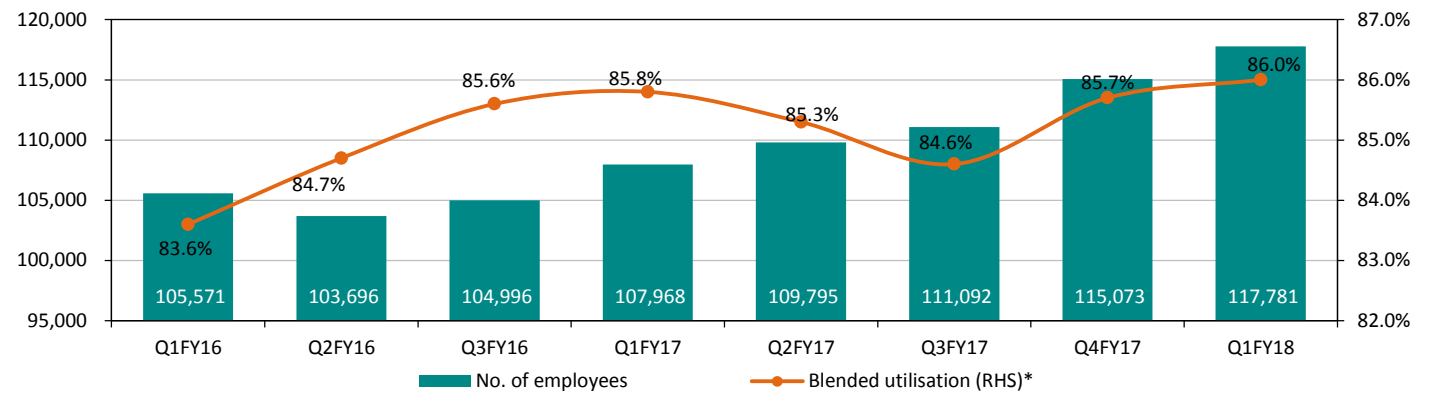
Source: Company; IDBI Capital Research

**Figure 2: Q1FY18 EBIT margin was a beat to our forecast**



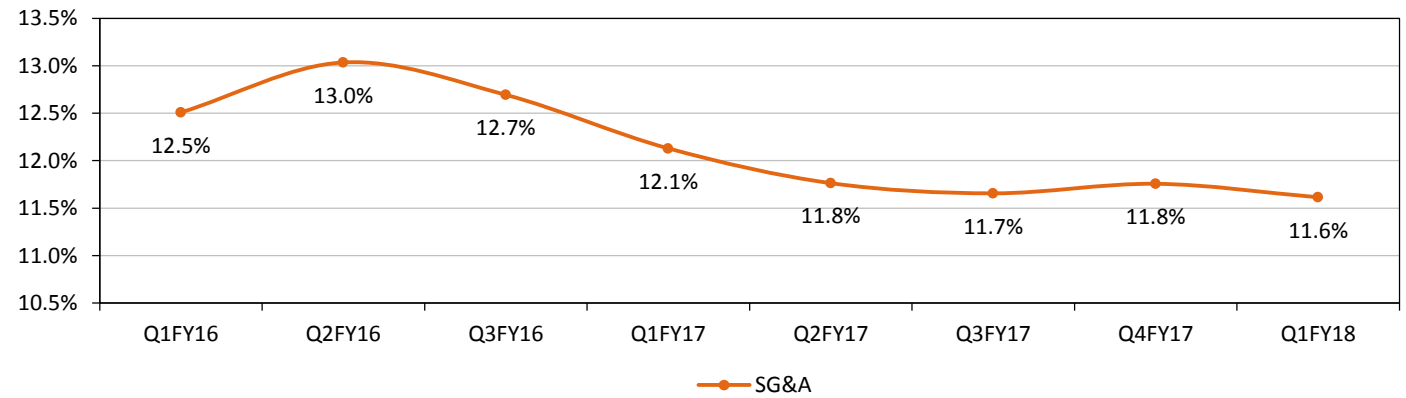
Source: Company; IDBI Capital Research

**Figure 3: Utilisation improved further in Q1FY18**



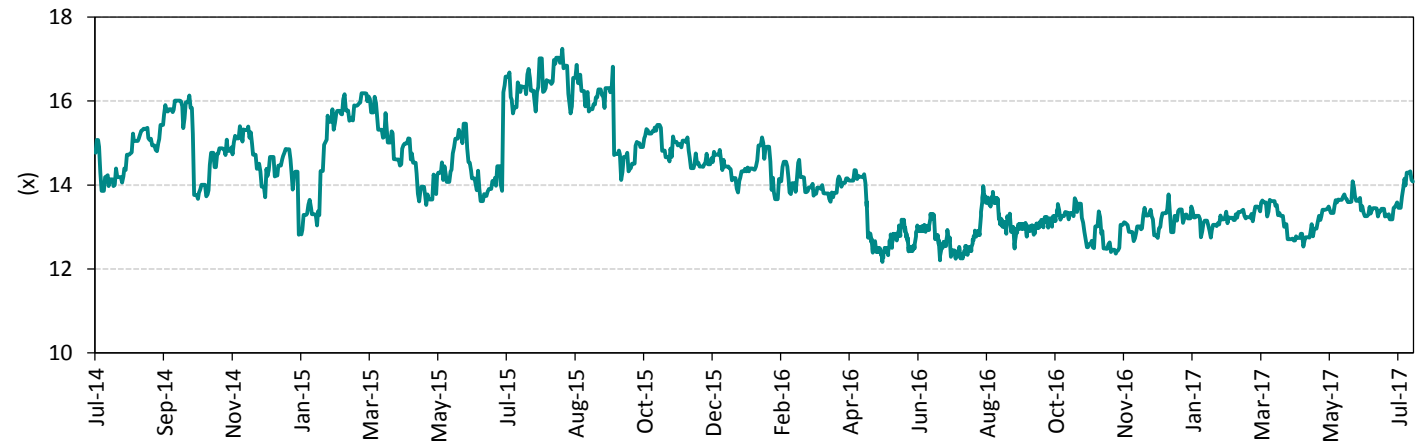
Source: Company; IDBI Capital Research

**Figure 4: SG&A remained steady in Q1FY18**



Source: Company; IDBI Capital Research

**Figure 5: One-year forward PER trend**



Source: Company; IDBI Capital Research

## Financial Summary

### Profit & Loss Account

(Rs mn)

Year-end: March	FY16	FY17	FY18E	FY19E
<b>Net sales</b>	<b>311,360</b>	<b>467,220</b>	<b>518,021</b>	<b>587,104</b>
<i>Growth (%)</i>	<i>(16.0)</i>	<i>50.1</i>	<i>10.9</i>	<i>13.3</i>
Operating expenses	(244,402)	(364,130)	(401,819)	(455,702)
<b>EBITDA</b>	<b>66,958</b>	<b>103,090</b>	<b>116,202</b>	<b>131,402</b>
<i>Growth (%)</i>	<i>(23.1)</i>	<i>54.0</i>	<i>12.7</i>	<i>13.1</i>
Depreciation	(4,450)	(8,340)	(10,547)	(11,510)
<b>EBIT</b>	<b>62,508</b>	<b>94,750</b>	<b>105,655</b>	<b>119,892</b>
Other income	7,970	9,340	10,116	9,413
<b>Pre-tax profit</b>	<b>70,478</b>	<b>104,090</b>	<b>115,771</b>	<b>129,306</b>
Tax	(20,196)	(19,520)	(24,032)	(27,154)
<i>Effective tax rate (%)</i>	<i>28.7</i>	<i>18.8</i>	<i>20.8</i>	<i>21.0</i>
<b>Net profit</b>	<b>50,282</b>	<b>84,570</b>	<b>91,738</b>	<b>102,151</b>
<b>Adjusted net profit</b>	<b>50,282</b>	<b>84,570</b>	<b>91,738</b>	<b>102,151</b>
<i>Growth (%)</i>	<i>(30.7)</i>	<i>68.2</i>	<i>8.5</i>	<i>11.4</i>
<i>Shares o/s (mnos)</i>	<i>1,410</i>	<i>1,413</i>	<i>1,378</i>	<i>1,378</i>

### Cash Flow Statement

(Rs mn)

Year-end: March	FY16	FY17	FY18E	FY19E
Pre-tax profit	70,478	104,090	115,771	129,306
Depreciation	1,235	8,340	10,496	11,796
Tax paid	(20,556)	(19,520)	(24,032)	(27,154)
Chg in working capital	(20,455)	13,021	(1,100)	10,696
Other operating activities	119	22,748	(64,600)	(16,893)
<b>Cash flow from operations (a)</b>	<b>30,820</b>	<b>128,679</b>	<b>36,534</b>	<b>107,750</b>
Capital expenditure	(18,581)	(63,788)	(18,000)	(20,000)
Chg in investments	(2,137)	1,739	-	-
Other investing activities	-	-	-	-
<b>Cash flow from investing (b)</b>	<b>(20,719)</b>	<b>(62,048)</b>	<b>(18,000)</b>	<b>(20,000)</b>
Equity raised/(repaid)	9	6	(70)	-
Debt raised/(repaid)	4,285	(4,101)	-	-
Dividend (incl. tax)	(23,977)	(33,919)	(11,026)	(37,214)
Chg in minorities	2,295	-	-	-
Other financing activities	-	-	-	-
<b>Cash flow from financing (c)</b>	<b>(17,388)</b>	<b>(38,014)</b>	<b>(11,096)</b>	<b>(37,214)</b>
<b>Net chg in cash (a+b+c)</b>	<b>(7,286)</b>	<b>28,616</b>	<b>7,438</b>	<b>50,537</b>



**Balance Sheet**

(Rs mn)

Year-end: March	FY16	FY17	FY18E	FY19E
Net fixed assets	105,614	161,062	168,566	176,770
Investments	3,205	1,466	1,466	1,466
Other non-curr assets	27,758	28,861	32,642	36,996
<b>Current assets</b>	<b>248,602</b>	<b>264,676</b>	<b>309,815</b>	<b>383,765</b>
Inventories	2,645	3,840	2,413	2,734
Sundry Debtors	76,818	83,014	90,831	102,944
Cash and Bank	98,202	126,818	134,256	184,793
Loans and advances	33,400	25,012	31,223	35,387
<b>Total assets</b>	<b>385,179</b>	<b>456,065</b>	<b>512,490</b>	<b>598,996</b>
<b>Shareholders' funds</b>	<b>272,942</b>	<b>331,787</b>	<b>375,249</b>	<b>432,595</b>
Share capital	2,821	2,827	2,757	2,757
Reserves & surplus	270,121	328,960	372,493	429,839
<b>Total Debt</b>	<b>9,518</b>	<b>5,417</b>	<b>5,417</b>	<b>5,417</b>
Secured loans	-	-	-	-
Unsecured loans	9,518	5,417	5,417	5,417
Other liabilities	151	4,268	5,729	7,594
<b>CurrLiab&amp;prov</b>	<b>99,452</b>	<b>111,477</b>	<b>122,978</b>	<b>150,273</b>
Current liabilities	81,415	89,318	109,281	123,855
Provisions	18,037	22,159	13,697	26,418
<b>Total liabilities</b>	<b>109,121</b>	<b>121,162</b>	<b>134,124</b>	<b>163,284</b>
<b>Total equity &amp; liabilities</b>	<b>385,179</b>	<b>456,065</b>	<b>512,490</b>	<b>598,996</b>
<b>Book Value (Rs)</b>	<b>194</b>	<b>235</b>	<b>272</b>	<b>314</b>

Source: Company; IDBI Capital Research

**Financial Ratios**

Year-end: March	FY16	FY17	FY18E	FY19E
Adj. EPS (Rs)	35.7	59.8	66.6	74.1
Adj. EPS growth (%)	-30.9	67.8	11.2	11.4
EBITDA margin (%)	21.5	22.1	22.4	22.4
Pre-tax margin (%)	22.6	22.3	22.3	22.0
ROE (%)	19.5	28.0	26.0	25.3
ROCE (%)	23.4	30.1	28.8	28.6
<b>Turnover &amp; Leverage ratios (x)</b>				
Asset turnover (x)	0.9	1.1	1.1	1.1
Leverage factor (x)	1.4	1.4	1.4	1.4
Net margin (%)	16.1	18.1	17.7	17.4
Net Debt/Equity (x)	(0.3)	(0.4)	(0.3)	(0.4)
<b>Working Capital &amp; Liquidity ratio</b>				
Inventory days	3	3	2	2
Receivable days	90	65	64	64
Payable days	10	10	8	8

**Valuation**

Year-end: March	FY16	FY17	FY18E	FY19E
P/E (x)	24.0	14.3	12.8	11.5
Price / Book value (x)	4.4	3.6	3.1	2.7
PCE (x)	22.0	13.0	11.5	10.4
EV / Net sales (x)	3.6	2.3	2.0	1.7
EV / EBITDA (x)	16.7	10.5	9.0	7.6
Dividend Yield (%)	2.0	2.8	0.9	3.2



# Notes

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**BUY:** Absolute return of 15% and above; **ACCUMULATE:** 5% to 15%; **HOLD:** Upto ±5%; **REDUCE:** -5% to -15%; **SELL:** -15% and below.

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