

HCL Technologies

HOLD

Product & ER&D key drag due to macro challenges

Summary

HCL Technologies (HCLT) reported healthy set of Q3FY23 numbers mainly led by strong growth in product revenues (up 30.5% QoQ). However, despite robust revenue growth the company has reiterated its guidance of 13.5% -14.0% in FY23E indicating de-growth in Q4 mainly led by lower product revenues and macro challenges. We believe challenges in Europe, lower discretionary spend, cyclicality in ER&D and soft product revenues will impact near term revenue growth. Although, the company will be able to benefit from vendor consolidation & improving margins, we believe macro challenges will keep financials under check. This coupled with run up in stock price prompt us to downgrade the stock from Buy to Hold with a revised target price of Rs 1,140 (18x PE on FY25E EPS).

Key Highlights and Investment Rationale

- Healthy order pipeline and cost take outs to drive growth:** HCL Technologies is witnessing healthy TCV of US\$2.4 bn. In addition, cost efficiency projects, synergy with products leading to mega deals (like the one won in Q2 which will contribute ~1% of revenues to FY24E), market share gain (led by vendor consolidation opportunity of US\$115 bn) and improvement in IT services will drive growth. However, macro challenges will keep revenue growth under pressure in medium term. Hence, we expect US\$ revenue CAGR of 9% over FY22-25E.
- Operating margins to improve gradually:** We expect margins to improve in coming years mainly led by higher utilisation, pyramid utilisation, offshoring and higher realisation. Hence, margins to improve by 40 bps & 10 bps YoY to 18.5% & 18.6% in FY24E.

TP	Rs 1,140
CMP	Rs 1,072
Potential upside/downside	6%
Previous Rating	BUY

Price Performance (%)

	-1m	-3m	-12m
Absolute	(3.1)	12.6	(20.7)
Rel to Sensex	0.9	8.5	(18.8)

V/s Consensus

EPS (Rs)	FY23E	FY24E	FY25E
IDBI Capital	53.2	57.4	63.3
Consensus	53.4	60.1	68.1
% difference	(0.4)	(4.5)	(7.0)

Key Stock Data

Bloomberg/Reuters	HCLT IN/ HCLT.BO
Sector	IT Services
Shares o/s (mn)	2,714
Market cap. (Rs mn)	2,908,778
3-m daily avg Trd value (Rs mn)	197.7
52-week high / low	Rs1,359 / 876
Sensex / Nifty	59,958 / 17,858

Shareholding Pattern (%)

Promoters	60.7
FII	17.2
DII	15.7
Public	6.4

Financial snapshot

(Rs mn)

Year	FY21	FY22	FY23E	FY24E	FY25E
Revenue	753,790	856,510	1,006,677	1,077,885	1,191,001
Change (yoy, %)	7	14	18	7	10
EBITDA	207,750	205,300	224,409	244,951	268,746
Change (yoy, %)	24	-1	9	9	10
EBITDA Margin (%)	27.6	24.0	22.3	22.7	22.6
Adj. PAT	129,410	134,990	144,532	155,811	171,823
EPS (Rs)	47.7	49.7	53.2	57.4	63.3
Change (yoy, %)	18	4	7	8	10
PE(x)	22	22	20	19	17
Dividend Yield (%)	2	4	4	5	5
EV/EBITDA (x)	13	13	12	11	10
RoE (%)	23.3	22.2	23.1	24.2	25.9
RoCE (%)	26	24	26	27	29

Source: IDBI Capital Research;

Other Key Highlights

- Overall revenue in CC terms grew by 5%/13.1% QoQ/YoY. Despite higher furloughs, growth was led by Services business which recorded CC growth of 2.2%/15.4% QoQ/YoY. Software business recorded impressive 30.5% QoQ growth as Q4 is a seasonally strong quarter. Management remains optimistic of the improvement in software business growth to continue going forward as it recorded 10 new deals.
- In terms of geographies, sequential growth in CC terms was led by Europe (+7.2%), followed by Americas (+0.5%). ROW declined by 1.2%. Growth in Europe despite slowdown was due to execution of 1 large deal.
- In terms of verticals, QoQ growth in CC terms was led by lifesciences (+5.5%), followed by Manufacturing (+4.9%), Telecom & media (+4.5%). Financial services & Retail contracted by 1.7% & 0.6% respectively due to higher furloughs. Demand in Hitech is impacted as clients remain cautious, this led to flattish quarter.
- EBIT margin improved 165 bps sequentially on the back of peak performance of software business and improvement in services business. Margin impact of employee compensation increment (-70bps) and higher furloughs (-60bps) was offset by forex gain (+70bps), improved realization (+30bps) and pyramid rationalization (+40bps).
- Company retained revenue growth guidance for FY23 of 13.5%-14% in CC terms as Q4 is expected to be comparatively weak for P&P due to seasonality. Services revenue is expected to grow at 16%-16.5% (earlier guidance of 16%-17%). Margin guidance retained at 18%-18.5%. However, HCL aims to achieve margins of 19%-20% for services business in the longer term led by improved utilization & realization.
- TCV & ACV of new bookings grew 10% and 2% YoY as HCL signed 17 large deals of which 7 were in the services business and balance in software business. Unqualified bookings remain very strong which could help in offsetting the demand slowdown in discretionary spends.
- Company stated that bookings in USA remained strong. Europe is observing delay in decision making. However the pipeline is strong and expects new deals to flow in during Q4FY23E and Q1FY24E.
- Added 2,945 employees (8,359 in previous quarter). Added 5,892 freshers (10,339 in previous quarter). LTM attrition reduced from 23.8% to 21.7% QoQ. Management expects further reduction in attrition going forward.

Exhibit 1: Financial snapshot

(Rs mn)

Year-end: March	Q3FY23	Q2FY23	QoQ (%)	Q3FY22	YoY (%)
Revenues (US\$ mn)	3,244	3,082	5.3	2,978	9.0
Revenues	267,000	246,860	8.2	223,310	19.6
COGS	171,350	162,370	5.5	141,790	20.8
Gross profit	95,650	84,490	13.2	81,520	17.3
SG&A	32,000	30,240	5.8	27,590	16.0
EBITDA	63,650	54,250	17.3	53,930	18.0
Depreciation & amortization	11,370	9,980	13.9	11,360	0.1
EBIT	52,280	44,270	18.1	42,570	22.8
Other income	1,440	1,570	(8.3)	1,730	(16.8)
PBT	53,720	45,840	17.2	44,300	21.3
Tax	12,760	10,960	16.4	9,820	29.9
Minority interest	0	(10)	<i>n.m.</i>	60	<i>n.m.</i>
Reported net profit	40,960	34,890	17.4	34,420	19.0
Diluted EPS (Rs)	15.1	12.9	17.4	12.7	19.3
As % of net revenue					
Gross profit	35.8	34.2		36.5	
SG&A	12.0	12.2		12.4	
EBITDA	23.8	22.0		24.2	
EBIT	19.6	17.9		19.1	
Reported net profit	15.3	14.1		15.4	
Tax rate	23.8	23.9		22.2	

Source: Company; IDBI Capital Research

Exhibit 2: Earnings Revision

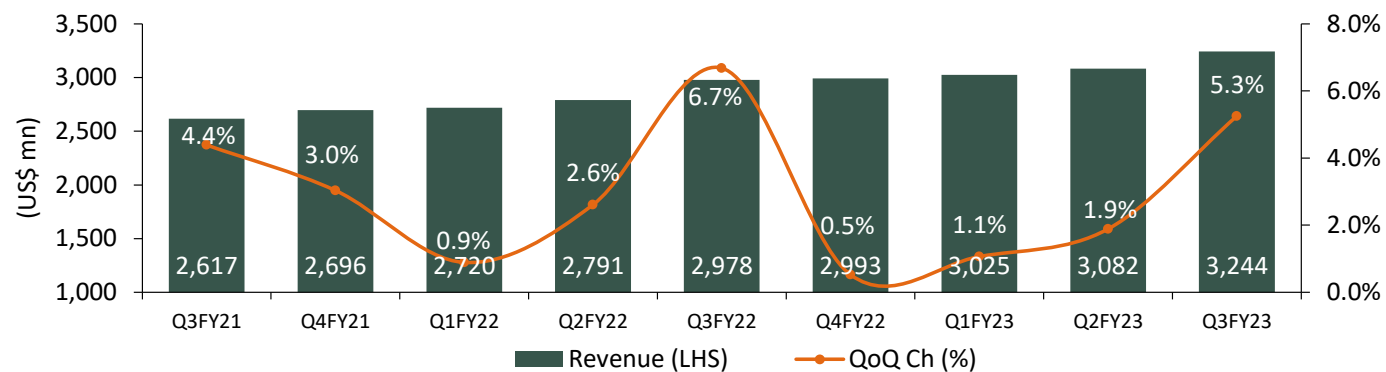
Year-end: March	FY23F			FY24E			FY25E
	New	Old	Chg (%)	New	Old	Chg (%)	Introduced
Revenue (US\$ mn)	12,574.3	12,670.6	(0.8)	13,456.7	13,833.7	(2.7)	14,868.9
Revenue (Rs bn)	1,006.7	1,007.2	(0.1)	1,077.9	1,108.1	(2.7)	1,191.0
EBIT (Rs bn)	182.5	183.6	(0.6)	199.7	206.3	(3.2)	221.4
<i>EBIT margin (%)</i>	18.13	18.23	(10) bps	18.53	18.62	(9) bps	18.59
EPS (Rs)	53.2	53.5	(0.5)	57.4	59.2	(3.1)	63.3

Source: Company; IDBI Capital Research

Exhibit 3: Actual vs. estimates

Year to March	Q3FY22	Q3FY22E	Variance (%)
Revenue (US\$ mn)	3,244	3,167	2.4
Revenue (Rs mn)	267,000	260,339	2.6
EBIT (Rs mn)	52,280	49,747	5.1
<i>EBIT margin (%)</i>	19.6%	19.1%	47bps
PAT (Rs mn)	40,960	34,900	17.4
<i>PAT margin (%)</i>	15.3%	13.4%	194bps
EPS (Rs)	15.1	12.9	17.4

Source: Company; IDBI Capital Research

Exhibit 4: Q3FY23 revenue growth was above our forecast


Source: Company; IDBI Capital Research

Exhibit 5: Growth in large clients

Year-end: March	Q4FY21	Q1FY22	Q2FY22	Q3FY22	Q4FY22	Q1FY23	Q2FY23	Q3FY23
US\$100m +	15	14	15	15	16	17	17	17
US\$50m +	35	37	41	42	43	42	42	45
US\$20m +	96	104	109	110	118	127	128	130
US\$10m +	178	178	190	198	208	218	220	221
US\$5m +	318	326	329	346	349	353	356	365
US\$1m +	809	817	836	864	882	880	890	937

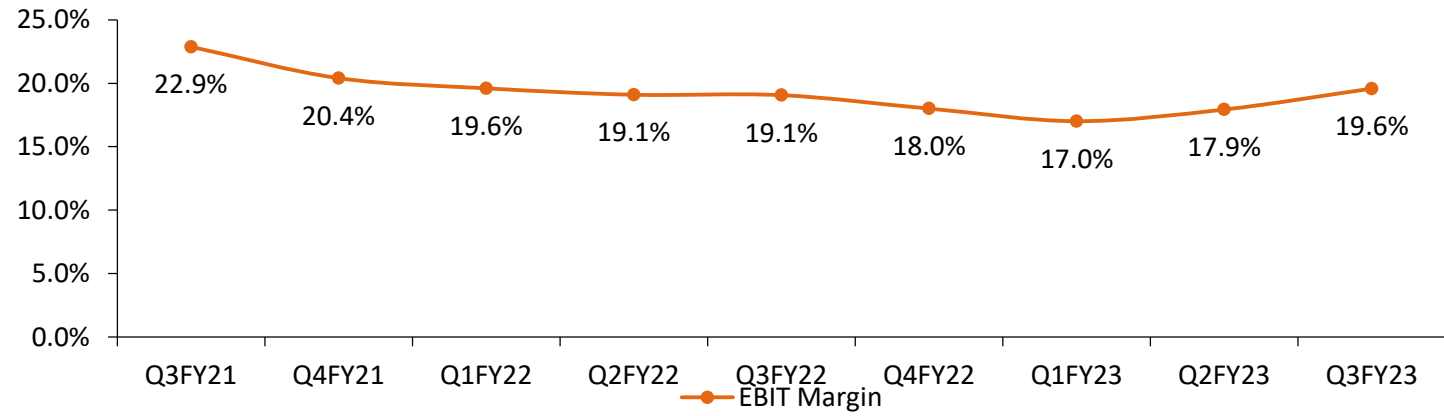
Source: Company; IDBI Capital Research

Exhibit 6: Revenue growth across various segments (%)

Parameters	% of revenue	QoQ CC growth	YoY CC growth
Overall revenue growth		5.0	13.1
Geography			
US	63.5	0.5	12.3
Europe	29.1	7.2	23.3
ROW	7.4	(1.2)	11.6
Service-lines			
IT and Business services	71.7	2.1	15.3
Engineering and R&D Services	16.6	2.5	16.0
Products and Platforms	11.8	30.5	(1.5)
Verticals			
Financial Services	19.9	(1.7)	8.8
Manufacturing	19.7	4.9	21.2
Technology & Services	14.8	0.1	19.3
Telecom &Media Publishing	9.4	4.5	27.9
Retail & CPG	8.9	(0.6)	(3.8)
Life science & Healthcare	17.1	5.5	19.5
Public Services	10.2	3.0	16.7

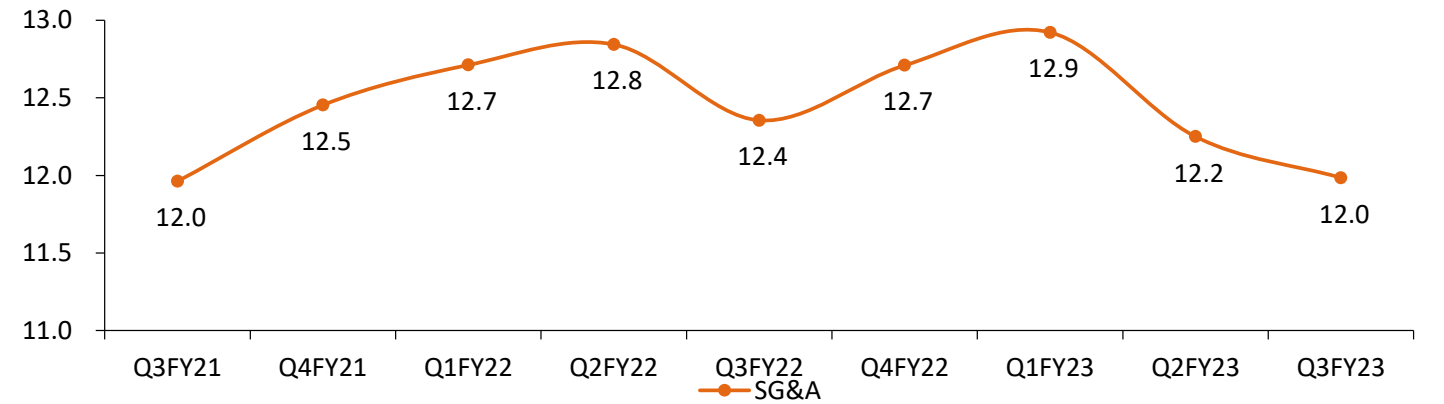
Source: Company; IDBI Capital Research

Exhibit 7: Q3FY23 EBIT margin was tad above our expectation



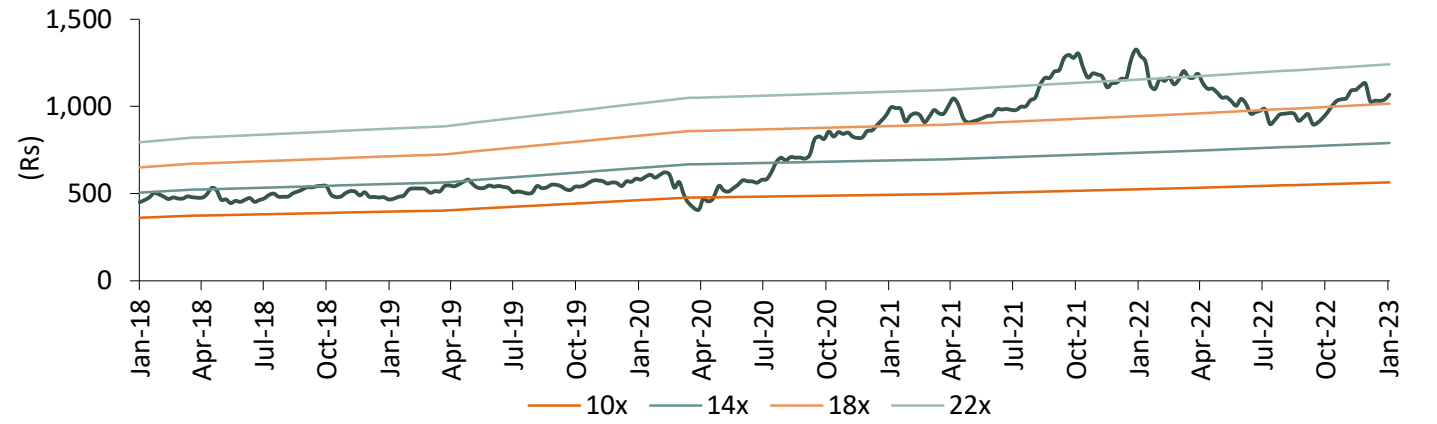
Source: Company; IDBI Capital Research

Exhibit 8: SG&A saw a QoQ decline



Source: Company; IDBI Capital Research

Exhibit 9: One-year forward PER trend



Source: Company; IDBI Capital Research

Financial Summary

Profit & Loss Account

(Rs mn)

Year-end: March	FY20	FY21	FY22	FY23E	FY24E	FY25E
Net sales	706,780	753,790	856,510	1,006,677	1,077,885	1,191,001
<i>Change (yoy, %)</i>	17	7	14	18	7	10
Operating expenses	(539,850)	(546,040)	(651,210)	(782,268)	(832,934)	(922,254)
EBITDA	166,930	207,750	205,300	224,409	244,951	268,746
<i>Change (yoy, %)</i>	20	24	-1	9	9	10
<i>Margin (%)</i>	23.6	27.6	24.0	22.3	22.7	22.6
Depreciation	(28,400)	(46,110)	(43,260)	(41,943)	(45,211)	(47,371)
EBIT	138,530	161,640	162,040	182,466	199,741	221,376
Interest paid	-	-	-	-	-	-
Other income	1,790	4,160	7,470	7,900	6,190	5,760
Pre-tax profit	140,320	165,800	169,510	190,366	205,931	227,136
Tax	(30,748)	(36,150)	(34,280)	(45,665)	(49,320)	(54,513)
<i>Effective tax rate (%)</i>	21.9	21.8	20.2	24.0	23.9	24.0
Minority Interest	(320.0)	(240.0)	(240.0)	(170.0)	(800.0)	(800.0)
Net profit	109,252	129,410	134,990	144,532	155,811	171,823
Exceptional items	-	-	-	-	-	-
Adjusted net profit	109,252	129,410	134,990	144,532	155,811	171,823
<i>Change (yoy, %)</i>	8	18	4	7	8	10
EPS	40.3	47.7	49.7	53.2	57.4	63.3
Dividend per sh	6	26	44	48	50	55
<i>Dividend Payout %</i>	18	55	88	90	87	87

Balance Sheet

(Rs mn)

Year-end: March	FY20	FY21	FY22	FY23E	FY24E	FY25E
Shareholders' funds	512,670	599,130	619,140	633,352	653,412	675,910
Share capital	5,427	5,427	5,430	5,430	5,430	5,430
Reserves & surplus	507,243	593,703	613,710	627,922	647,982	670,480
Total Debt	46,930	38,280	39,230	39,230	39,230	39,230
Other liabilities	25,900	37,200	31,530	52,781	57,267	64,393
Curr Liab & prov	218,850	173,830	187,750	242,624	258,573	284,834
Current liabilities	201,100	151,370	164,820	205,016	219,023	241,275
Provisions	17,750	22,460	22,930	37,608	39,549	43,560
Total liabilities	291,680	249,310	258,510	334,634	355,069	388,457
Total equity & liabilities	805,890	850,130	878,570	969,076	1,010,371	1,067,058
Net fixed assets	352,420	350,470	329,010	311,192	283,982	254,611
Investments	770	890	1,030	1,030	1,030	1,030
Other non-curr assets	66,700	68,260	68,120	91,015	97,453	107,680
Current assets	386,000	430,510	480,410	565,839	627,907	703,737
Inventories	910	940	1,610	1,379	1,477	1,632
Sundry Debtors	141,310	136,630	154,760	182,029	194,905	215,359
Cash and Bank	119,650	156,610	188,750	192,127	227,761	261,598
Loans and advances	34,220	48,410	30,080	66,192	70,875	78,312
Total assets	805,890	850,130	878,570	969,076	1,010,371	1,067,058

Cash Flow Statement

(Rs mn)

Year-end: March	FY20	FY21	FY22	FY23E	FY24E	FY25E
Pre-tax profit	140,320	165,800	169,510	190,366	205,931	227,136
Depreciation	19,000	46,110	43,260	41,943	45,211	47,371
Tax paid	(30,758)	(24,190)	(34,580)	(45,665)	(49,320)	(54,513)
Chg in working capital	57,750	(54,560)	13,450	(8,277)	(1,707)	(1,785)
Other operating activities	(17,980)	27,375	(18,043)	(20,629)	(15,197)	(12,388)
Cash flow from operations (a)	168,331	160,535	173,597	157,738	190,348	205,821
Capital expenditure	(140,190)	(44,160)	(21,800)	(24,125)	(18,000)	(18,000)
Chg in investments	80	(120)	(140)	-	-	-
Other investing activities	-	-	-	-	-	-
Cash flow from investing (b)	(140,110)	(44,280)	(21,940)	(24,125)	(18,000)	(18,000)
Equity raised/(repaid)	2	-	3	-	-	-
Debt raised/(repaid)	9,920	(8,650)	950	-	-	-
Dividend (incl. tax)	(19,604)	(70,555)	(119,460)	(130,320)	(135,750)	(149,325)
Chg in minorities	190	(90)	(1,010)	-	-	-
Other financing activities	-	-	-	-	-	-
Cash flow from financing (c)	(9,491)	(79,295)	(119,517)	(130,320)	(135,750)	(149,325)
Net chg in cash (a+b+c)	18,730	36,960	32,140	3,293	31,168	38,496

Financial Ratios

Year-end: March	FY20	FY21	FY22	FY23E	FY24E	FY25E
Book Value (Rs)	189	221	228	233	241	249
Adj EPS (Rs)	40.3	47.7	49.7	53.2	57.4	63.3
Adj EPS growth (%)	8	18	4	7	8	10
EBITDA margin (%)	24	28	24	22	23	23
Pre-tax margin (%)	20	22	20	19	19	19
Net Debt/Equity (x)	0	0	0	0	0	0
ROCE (%)	27	26	24	26	27	29
ROE (%)	23.6	23.3	22.2	23.1	24.2	25.9

DuPont Analysis

Asset turnover (x)	1.0	0.9	1.0	1.1	1.1	1.1
Leverage factor (x)	1.5	1.5	1.4	1.5	1.5	1.6
Net margin (%)	15.5	17.2	15.8	14.4	14.5	14.4

Working Capital & Liquidity ratio

Inventory days	0	0	1	1	1	1
Receivable days	73	66	66	66	66	66
Payable days	8	12	13	13	13	13

Valuations

Year-end: March	FY20	FY21	FY22	FY23E	FY24E	FY25E
PER (x)	26.6	22.5	21.6	20.1	18.7	16.9
Price/Book value (x)	5.7	4.9	4.7	4.6	4.5	4.3
EV/Net sales (x)	4.0	3.7	3.2	2.7	2.5	2.3
EV/EBITDA (x)	17	13	13	12	11	10
Dividend Yield (%)	1	2	4	4	5	5

Source: Company; IDBI Capital Research



Notes

Dealing

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Key to Ratings Stocks:**BUY:** 15%+; **HOLD:** -5% to 15%; **SELL:** -5% and below.**IDBI Capital Markets & Securities Ltd.****Equity Research Desk**

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