Company Update

HCL Technologies

13 November 2019

Reuters: HCLT.BO; Bloomberg: HCLT IN

Software will be the big valuation swing factor

Despite likely delivery of the best organic revenue growth among its peers in FY20 and margins which are respectable, market will likely continue to give HCL Technologies (HCLT) a big discount to valuation of TCS – the industry leader. This largely stems from the dim view that it has taken on the US$3.1bn bet HCLT has placed on developing an enterprise product business. We have been a bit more constructive on that part of the business vis-à-vis consensus (A Low-cost Call Option). Should it make a success of this effort we believe the multiple expansion could be significant. While HCL Software business as a separate entity has been created, it has a long way to go for investors to call it a success. From what we could gather at the recent analyst meet and recent interactions that HCLT has had with investors, no specifics on growth have been shared with the investors, though an EBIDTA/EBIT margin profile of 50%/30% has been indicated. HCLT has apparently made post tax USD IRRs of 18% on its partnership deals against an internal threshold of 12-15%. The enterprise software profit pool according HCLT is the largest in the technology industry and it wants to get a share of this. In a way this is an ambitious extension of its outsourced software product engineering capabilities which it has been running for many decades where HCLT says that it has helped generate US$50bn of revenue for its clients. Outside of core banking products that players like TCS and Infosys have created no other player in the Indian market has the multi-country go-to-market capability and an installed base of clients that HCLT has, post its takeover of the 7 products from IBM and their respective sales and product teams. Key to its success in the software product business would be (1) the lowest unit cost of innovation through a largely India based product development team (2) being the most customer friendly software company which is focused more on customer value generation involving more frequent modernization of the products rather than just software sales (3) keeping the product business independent from the services business while trying to find a balance on the cross sell aspect so as not to put off customers and resellers/partners. If the company is able to eke out even a low to mid-single digit growth from its existing portfolio of products over the medium term with the post-tax IRRs in line with its own projections, we see significant scope for value creation. Besides product revenues are very sticky with about 90% being annuity in nature. We reiterate our Accumulate rating on HCLT with a September 2021E target price (TP) of Rs1153. We value HCLT at a target P/E of 13.2x1HFY22E EPS, which is at a 20% discount to the target P/E multiple of TCS. Just to put this in context, our target P/E on Infosys is at a 10% discount to TCS'. The current discount is justified as TCS will likely grow organically at about the same pace as HCLT in the medium term but has more diversified revenue streams and capabilities. TCS will also have a better RoIC over the forecasted period. HCLT will suffer from the return-dilutive (at least in the initial phase) but margin-accretive IP acquisitions.

HCL Software Business launched: We believe the new business unit encompasses all the IBM IP partnerships, IBM-IP acquisition, other acquired IP as well as internally developed ones. This will come under the umbrella of 'Mode 3' revenue. 2QFY20 saw US$290mn of revenue and 32.9% EBIT margin. Management commentary indicates that over 12 months the acquired IBM-IP may fall short of its US$625mn target by a tad. However, it has got 25,000 corporate customers from this acquisition globally and has started signing up renewal contracts with them under the HCL umbrella. Initial feedback indicates no customer resistance for the same and the terms on which renewals are happening are at par with the old ones with IBM. The entire customer migration process could take 12 months as most contacts are annual in nature. The customer base has provided opportunities for HCLT to cross-sell its other products and services. In 2Q itself, HCLT has started getting deals from cross sell (a US$20mn deal from an Australian retail client for e.g.). Management indicated that there may not be as significant a seasonality in the acquired product business as was there when the products were under IBM. However, it indicated that December quarter is likely to be strongest.

Why go the mature product route: HCLT is of the view that there is value in incumbency - it is easier to "renovate" and "transform" an installed product in an existing customer than win a new one - cost of retaining a new customer is lower compared to acquiring a new one. It discussed the cases of existing successful product companies like SAP which have 30 year old core products but have remained relevant due to constant innovation. Those that did not move with the times like Siebel or Peoplesoft faded away. It was also of the view that Customer IT estates change more slowly than the marketing hype curve. It is also of the view that the existing large software vendors in the market are too focused on pushing sales of new licenses rather than focus on mature products or on better customer service on them – leaving room for players like HCLT to make an entry. It indicated that on many of the products that it acquired from IBM, there had been no major upgrade or a release of new version for as many as 5 years or more. The criteria to decide which products to engage with or buy: (1) whether they address a key problem within large enterprises and whether this situation will continue for another 10 years (2) whether an opportunity to innovate and modernize exists on the product. HCLT also mentioned the case of large switching costs for customers when they try to shift to different products from their mature ones. HCLT indicated that it has been able to regain relationships on the basis of new software roadmaps on the mature products. Being the most customer friendly software company involves removing opacity in licensing agreements and sharing roadmaps on products.

ACCUMULATE

Sector: Information Technology

CMP: Rs1,146

Target price: Rs1,153

Upside: 1%

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Key Data

Current Shares O/S (mn)	1,356.6
Mkt Cap6 (Rsbn/US$bn)	1,554.6/21.8
52 Wk H / L (Rs)	1,190/920
Daily Vol. (3M NSE Avg.)	2,134,347

Price Performance (%)

	1 M	6 M	1 Yr
HCL Technologies	6.2	5.5	11.5
Nifty Index	5.4	5.6	12.5

Source: Bloomberg

Exhibit 1: Key financials

Y/E March (Rsmn)	FY18	FY19	FY20E	FY21E	FY22E
Revenue (Rsmn)	505,700	604,280	716,737	768,511	821,345
YoY Growth (%)	*8.2*	*19.5*	*18.6*	*7.2*	*6.9*
EBIT (Rsmn)	99,880	118,210	138,378	147,280	157,398
EBIT (%)	*19.8*	*19.6*	*19.3*	*19.2*	*19.2*
Adj. PAT (Rsmn)	87,820	101,230	107,406	114,187	122,926
YoY Growth (%)	*4.0*	*15.3*	*6.1*	*6.3*	*7.7*
FDEPS (Rs)	62.9	73.5	79.2	84.2	90.6
ROE (%)	*25.0*	*25.8*	*23.8*	*22.8*	*22.7*
ROCE (%)	*27.1*	*27.4*	*26.3*	*24.8*	*24.8*
Pre Tax ROIC (%)	*38.9*	*36.3*	*31.1*	*28.2*	*29.7*
P/E(x)	18.2	15.6	14.5	13.6	12.6
P/BV (x)	4.4	3.8	3.2	3.0	2.8

Source: Company, Nirmal Bang Institutional Equities Research

View on Indian IT services sector: We went back to being cautious on the Indian IT sector in late December 2018 (see report: Street Is Not Factoring Even A Soft Landing; We Downgrade) after being 'Tactically bullish' on it through most of 2018. This is based on: (1) Consensus not factoring in significantly softer growth in FY21 as the best demand environment since 2008-09 is largely behind us with corporate capex in both the US and Europe likely to have peaked in 2018. (2) Global BFSI customers could witness pressure on margins from a flattened/inverted yield curve and negative yields across a large part of European bonds (see our recent note Global BFSI malaise) and could therefore curtail IT spending (3) Pressure on cost structure because of tariffs levied on imports from China impacting US manufacturers. (4) Front-office capabilities in digital still largely eluding Indian IT services players, leading to inability to tap into the marketing budgets of customers in a material way. The focus has been on the technology-intensive back-end of digital where we believe the field is relatively more crowded. (5) 'Automation at scale' in legacy services constricting the opportunity being addressed by the Indian Industry. This is driven by explosive growth in both intelligent and robotic process automation software industry. (6) Capital return to shareholders not being as potent a stock driver as it was earlier as the cash hoard is shrinking after two to three rounds of buyback over the past four years. Besides, recent taxation introduced on buybacks could be a dampener (7) Talent pressure in the US in new age services because of a tighter H1-B visa regime. We reiterate our no-industry-growth-in-FY21 call initiated in March 2018. We base this scenario on an explicit expectation of a soft landing in the US (0%-1.5% real GDP growth) in 2020. We believe consensus is expecting mid-high single-digit revenue growth in FY21 for the industry, implicitly assuming continued robust growth in the US (2%-2.5%). It is our belief that the street will converge with our no-growth expectations over time. Until the market prices in this scenario, we believe technical factors are not likely to hold the sector up. A hard landing (recession) - not our current base case - could lead to single-digit negative growth for the sector. Just as outperformance of the sector in 2018 was driven largely by P/E multiple expansion in the belief that growth is going to accelerate, we believe the downside in 2019 will be driven by P/E multiple deflation as investors begin to re-calibrate growth expectations on FY20-FY22. We prefer large-caps over mid-caps. The faster growth shown by select mid-caps is a case of 'rising tide lifting all boats', a smaller base and lower exposure to legacy services. But as digital demand shifts from the front to back, we believe that traditional large Indian companies will be in a better position to capture the market. We would advise investors to focus on sustainability and not overpay for a riskier business model - some companies have seen client concentration rising over the past two years.

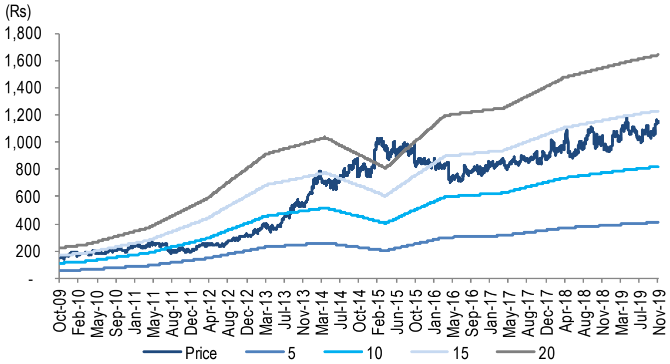
HCL Software – More details

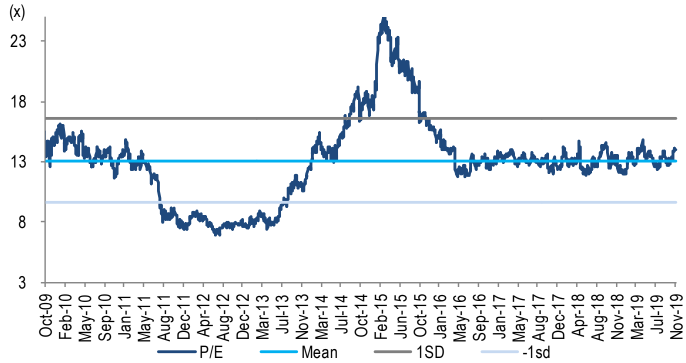
- HCL Software, a new business unit of HCL Products & Platforms, became operational in 2QFY20. The unit got off to a fast start in its first quarter of operations – engaging with thousands of new customers (apparently has 25,000 customers) through multiple channels, on boarding more than 1300 partners and resellers, and completing over 1500 total sales transactions, comprising both renewals and new licenses, in about 60 countries. The HCL Software business also announced its first major new product release of HCL Digital Experience 9.5, incorporating several core HCL Software, architectural priorities around containerization, micro-services and UI/UX improvements.
- HCLT indicated that there was no resistance from customers to shifting from IBM to HCLT as the latter is able to provide product roadmaps unlike in the past. It is able to provide services also surrounding these

products. The terms and conditions on which the renewals have happened have been broadly along the lines of the old contracts.

- New contracts are being signed under the name of HCL Software and the whole process of migrating about 25,000 customers would take about 1 year as most of these contracts are annual in nature with a few being of 2-3 years.
- The US$1.8bn IBM IP acquisition is a part of Mode 3 services. The transaction closed in end of June 2019. The acquisitions are mainly in the areas of Security, Marketing, Commerce and Collaboration. The IPs include AppScan, BigFix, Commerce, Connections, Digital Experience (Portal and Content Manager), Notes Domino, and Unica. Out of the US$1.8bn consideration for the deal, about half (US$800mn) has been paid out before 30th June 2019. A similar number will be paid out 12 months later. The second component of US$150 million (earn out) is payable in three installments.
- As regards Mode 3 revenue, HCLT stated that it will continue to invest in acquiring attractive and value-adding IPs in the long term and also keep investing in its own 'DryIce' automation platform, which is helping it drive Mode 1 and Mode 2 revenue growth. However, over the next 12-18 months we believe the focus of the company would be to consolidate its acquisition of IBM products. In Mode 3, HCLT will focus on rolling out SaaS and embracing a lot of architectural modernization as well as simplified commercial models around the products in this portfolio.
- HCL Software currently has 3200 employees with about 1750 product engineers, 600 customer support engineers, 400 sales employees in more than 20 countries. The sales team for HCL Software is only focused on doing product sales and not on services sales at all. The cross sell is being handled separately.
- HCLT is of the view that buying mature products and modernizing them is a strategy with low downside and significant upside. It is of the view that many customers (especially in BFSI and government sectors) do not want to move to the cloud immediately and run it on premises. Hence, it is of the view that modernization would not automatically imply SAAS or cloud-based versions of the old products.
- The large footprint of these products would automatically make HCLT entry into some countries easier. According to HCLT, it could potentially be the second largest India based company in a large IT spending market like Japan.
- Among the achievements of the HCL Software business is it had 460 product releases over the last 3 years since the product business was incubated including ~25 major releases.

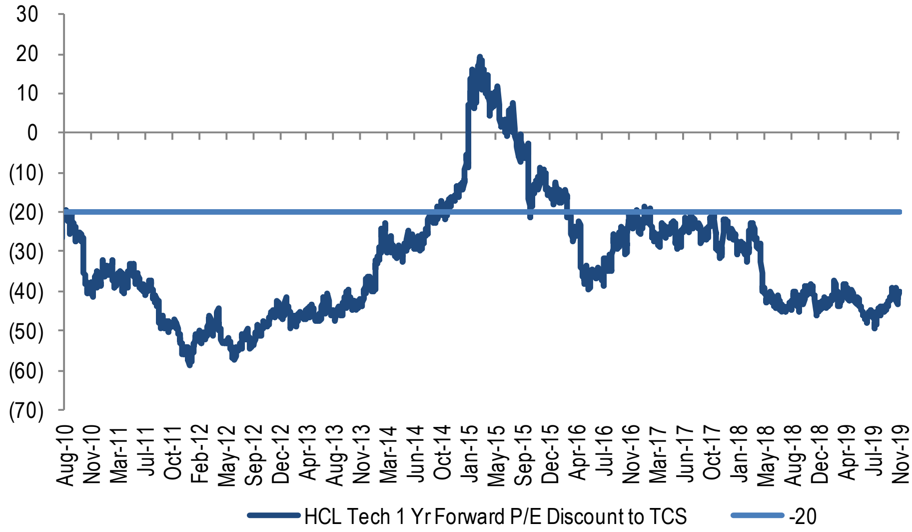
Exhibit 2: P/E charts





Source: Nirmal Bang Institutional Equities Research

Exhibit 3: HCLT'sone-year forward P/E discount to TCS



Source: Nirmal Bang Institutional Equities Research

Exhibit 4: Comparative valuation

	TCS	Infosys	Wipro	HCL Tech	TechMahindra	Mindtree	Persistent
Year Ending	**March**	**March**	**March**	**March**	**March**	**March**	**March**
Prices as on 11-Nov-19	**2,101**	**704**	**256**	**1,146**	**770**	**690**	**617**
Currency	**INR**	**INR**	**INR**	**INR**	**INR**	**INR**	**INR**
Market Value (Rs Bn)	8,044	3,062	1,266	1,554	679	114	49
(US$mn)	111,717	42,524	17,588	21,587	9,434	1,585	685
September 2021 Target Price	1,593	625	221	1,153	575	532	554
Upside/(downside)	-24.2%	-11.2%	-13.8%	0.7%	-25.3%	-22.9%	-10.3%
Recommendation	Sell	Sell	Sell	Accumulate	Sell	Sell	Sell
FDEPS (Rs)							
FY18	67.0	32.5	16.8	62.9	42.8	34.6	40.4
FY19	83.1	36.0	18.6	73.5	48.1	45.8	44.1
FY20E	89.5	39.9	17.4	79.2	52.3	38.3	54.7
FY21E	93.0	41.5	18.7	84.2	56.0	50.3	54.7
FY22E	100.1	42.8	19.6	90.6	60.2	57.1	57.2
PE (x)							
FY18	31.4	21.7	15.3	18.2	18.0	19.9	15.3
FY19	25.3	19.6	13.8	15.6	16.0	15.1	14.0
FY20E	23.5	17.6	14.7	14.5	14.7	18.0	11.3
FY21E	22.6	17.0	13.7	13.6	13.8	13.7	11.3
FY22E	21.0	16.5	13.1	12.6	12.8	12.1	10.8
EV/EBITDA (x)							
FY18	23.5	15.2	12.7	12.8	13.2	15.1	9.9
FY19	18.9	13.8	10.1	10.6	9.3	10.5	7.2
FY20E	18.5	12.6	9.6	9.5	8.8	10.2	6.6
FY21E	17.5	12.0	8.8	8.7	7.4	7.7	6.0
FY22E	16.2	11.6	8.2	8.0	6.7	6.8	5.3
EV/Sales (x)							
FY18	6.2	4.1	2.4	2.9	2.0	2.1	1.5
FY19	5.2	3.5	2.0	2.4	1.7	1.6	1.2
FY20E	4.8	3.2	1.9	2.2	1.6	1.5	1.1
FY21E	4.6	2.9	1.8	2.0	1.4	1.3	1.0
FY22E	4.3	2.8	1.6	1.8	1.2	1.2	0.9
Pre Tax ROIC (%)							
FY18	57.3	44.9	24.5	38.9	25.8	32.9	29.7
FY19	61.8	47.5	30.4	36.3	37.9	46.4	44.2
FY20E	55.3	47.5	34.7	31.1	36.4	33.1	40.8
FY21E	55.0	46.8	35.1	28.2	36.8	39.7	33.9
FY22E	57.6	38.6	36.0	29.7	38.4	44.9	32.6

Source: Nirmal Bang Institutional Equities Research

Financials

Exhibit 5: Income statement

Y/E March (Rsmn)	FY18	FY19	FY20E	FY21E	FY22E
Average INR/USD	**64.5**	**69.9**	**72.3**	**74.6**	**76.4**
Net Sales (USD mn)	**7,838**	**8,633**	**9,971**	**10,308**	**10,751**
YoY Growth (%)	***12.4***	***10.1***	***15.5***	***3.4***	***4.3***
INR Net Sales	**505,700**	**604,280**	**716,737**	**768,511**	**821,345**
YoY Growth (%)	*8.2*	*19.5*	*18.6*	*7.2*	*6.9*
Cost of Sales & Services	332,370	392,680	459,243	490,789	524,782
Gross Margin	**173,330**	**211,600**	**257,494**	**277,722**	**296,563**
% of sales	*34.3*	*35.0*	*35.9*	*36.1*	*36.1*
SG&A	58,930	71,910	92,683	101,411	109,814
% of sales	*11.7*	*11.9*	*12.9*	*13.2*	*13.4*
EBITDA	**114,400**	**139,690**	**164,811**	**176,311**	**186,749**
% of sales	*22.6*	*23.1*	*23.0*	*22.9*	*22.7*
Depreciation & Amortization	14,520	21,480	26,432	29,031	29,351
Dep. & Amortization (as % of sales)	*2.9*	*3.6*	*3.7*	*3.8*	*3.6*
EBIT	**99,880**	**118,210**	**138,378**	**147,280**	**157,398**
% of sales	***19.8***	***19.6***	***19.3***	***19.2***	***19.2***
Other income (net) (incl forex gain/loss)	11,110	8,050	2,914	2,765	4,131
PBT	110,990	126,260	141,293	150,045	161,528
Provision for tax	23,170	25,030	33,887	35,858	38,602
Effective tax rate (%)	*20.9*	*19.8*	*24.0*	*23.9*	*23.9*
Minority Interest	0	0	0	0	0
Net profit	**87,820**	**101,230**	**107,406**	**114,187**	**122,926**
-Growth (%)	*4.0*	*15.3*	*6.1*	*6.3*	*7.7*
-Net profit margin (%)	*17.4*	*16.8*	*15.0*	*14.9*	*15.0*

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 6: Cash flow

Y/E March (Rsmn)	FY18	FY19	FY20E	FY21E	FY22E
EBIT	**99,880**	**118,210**	**138,378**	**147,280**	**157,398**
(Inc.)/Dec. in Working Capital	(22,249)	(23,150)	(13,834)	9,152	(8,140)
Cash flow from Operations	**77,631**	**95,060**	**124,544**	**156,432**	**149,257**
Other Income	11,110	8,050	2,914	2,765	4,131
Depreciation & Amortisation	14,520	21,480	26,432	29,031	29,351
Tax Paid	(23,170)	(25,030)	(33,887)	(35,858)	(38,602)
Dividends Paid	(21,952)	(13,257)	(42,493)	(78,451)	(78,451)
Net Cash from Operations	**58,139**	**86,303**	**77,511**	**73,919**	**65,686**
Capital Expenditure	(49,354)	(60,536)	(144,655)	(32,951)	(33,271)
Net Cash after Capex	8,785	25,767	(67,144)	40,968	32,414
Inc./(dec.) in Debt	(1,046)	35,489	25,010	0	0
(Inc.)/Dec. in Investments	28,503	12,285	15,327	(41,076)	(34,857)
Equity Issue/(Buyback)	(35,002)	(40,000)	0	0	0
Cash from Financial Activities	(7,545)	10,292	29,301	27,453	27,453
Others	2,534	6,292	(4,307)	(68,421)	(59,867)
Opening Cash	13,165	16,939	59,290	17,140	17,140
Closing Cash	16,939	59,290	17,140	17,140	17,140
Change in Cash	3,774	42,351	(42,150)	(0)	0

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 7: Balance sheet

Y/E March (Rsmn)	FY18	FY19	FY20E	FY21E	FY22E
Equity capital	1,392	1,356	1,356	1,356	1,356
Minority Interest	4,260	4,540	4,660	4,660	4,660
Reserves & surplus	366,776	416,344	481,673	517,408	561,883
Net worth	**368,168**	**422,240**	**483,029**	**518,765**	**563,240**
Other liabilities	12,669	15,380	22,830	22,939	25,381
Total loans	4,371	39,860	43,070	43,070	43,070
Lease Liabilites	-	-	21,800	21,800	21,800
Total liabilities	**385,208**	**477,480**	**575,389**	**611,233**	**658,150**
Intangible assets	144,057	176,950	0	0	0
Net block	51,847	58,010	353,182	357,102	361,022
Investments	5,222	3,900	890	890	890
Other non-Current assets	37,675	52,930	62,249	62,544	69,203
Debtors	122,575	146,100	176,936	177,774	196,700
Cash & bank balance	16,939	59,290	17,140	17,140	17,140
Other Current assets	106,036	91,780	93,865	134,935	169,645
Right of use assets	-	-	23,330	23,330	23,330
Total Current assets	245,550	297,170	311,271	353,179	406,815
Total Current liabilities	99,143	111,480	152,203	162,482	179,780
Net Current assets	146,407	185,690	159,068	190,697	227,035
Total assets	**385,208**	**477,480**	**575,389**	**611,233**	**658,150**

Source: Company, Nirmal Bang Institutional Equities Research

Exhibit 8: Key ratios

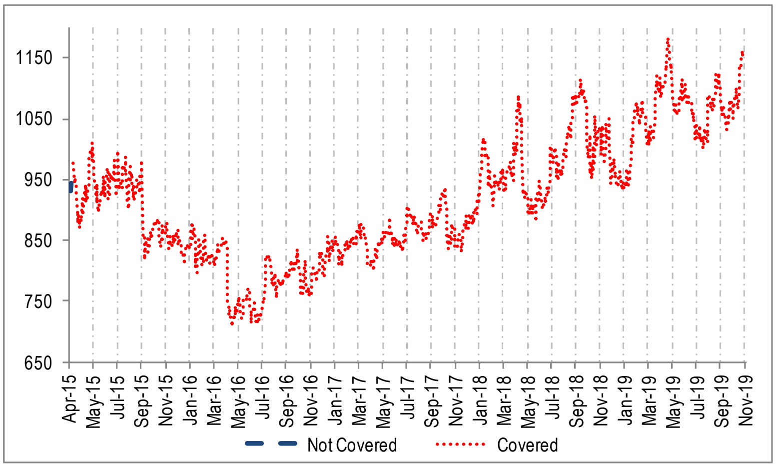
Y/E March (Rsmn)	FY18	FY19	FY20E	FY21E	FY22E
Per Share (Rs)					
EPS	62.7	73.6	79.2	84.2	90.6
FDEPS	62.9	73.5	79.2	84.2	90.6
Dividend Per Share	13.0	8.0	26.0	48.0	48.0
Dividend Yield (%)	1.1	0.7	2.3	4.2	4.2
Book Value	263	304	356	382	415
Dividend Payout Ratio (excl. DDT)	20.7	10.9	32.8	57.0	53.0
Return ratios (%)					
RoE	25.0	25.8	23.8	22.8	22.7
RoCE	27.1	27.4	26.3	24.8	24.8
RoIC	38.9	36.3	31.1	28.2	29.7
Turnover Ratios					
Asset Turnover Ratio	1.0	1.0	1.0	1.0	1.0
Debtor Days (incl. unbilled Rev.)	88	88	90	84	87
Working Capital Cycle Days	35	43	44	36	38
Valuation ratios (x)					
P/E	18.2	15.6	14.5	13.6	12.6
P/BV	4.4	3.8	3.2	3.0	2.8
EV/EBITDA	12.8	10.6	9.5	8.7	8.0
EV/Sales	2.9	2.4	2.2	2.0	1.8
M-cap/Sales	3.1	2.6	2.2	2.0	1.9

Source: Company, Nirmal Bang Institutional Equities Research

Rating track

Date	Rating	Market price (Rs)	Target price (Rs)
13 April 2015	Accumulate	959	1,013
22 April 2015	Accumulate	895	1,014
4 August 2015	Accumulate	938	1,008
1 October 2015	Accumulate	982	991
5 October 2015	Accumulate	859	991
20 October 2015	Buy	859	989
8 January 2016	Under Review	828	-
20 January 2016	Under Review	841	-
14 March 2016	Sell	824	737
29 April 2016	Sell	799	719
4 August 2016	Sell	826	745
24 October 2016	Sell	832	718
10 January 2017	Sell	838	712
25 January 2017	Sell	849	718
14 February 2017	Sell	827	740
12 May 2017	Sell	839	743
21 June 2017	Sell	854	713
28 July 2017	Sell	899	764
28 September 2017	Sell	874	744
26October 2017	Sell	903	763
26 December 2017	Under Review	887	-
22 January 2018	Under Review	958	-
17 March 2018	Accumulate	968	1,048
16 April 2018	Accumulate	991	1,048
3 May 2018	Accumulate	1,001	1,041
3 July 2018	Buy	926	1,131
30 July 2018	Buy	963	1,172
5 October 2018	Buy	1,081	1,281
24 October 2018	Buy	952	1,277
11 December 2018	Buy	942	1,329
27 December 2018	Accumulate	942	1,072
7 January 2019	Accumulate	932	958
30 January 2019	Accumulate	988	1,054
19 March 2019	Accumulate	1,012	1,076
10 May 2019	Accumulate	1,139	1,090
13 August 2019	Accumulate	1,083	1,127
23 August 2019	Accumulate	1,026	1,150
24 October 2019	Accumulate	1,102	1,153
13 November 2019	Accumulate	1,146	1,153

Rating track graph



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Disclaimer

Stock Ratings Absolute Returns

BUY > 15%

ACCUMULATE -5% to15%

SELL < -5%

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