PhillipCapital

HCL Technologies (HCLT IN)

On the right track; attractive after correction – Upgrade

INDIA | IT SERVICES | Company Update

27 April 2017

HCLT's stock price has corrected 8% over the last month amidst weakness in the entire IT sector and proposals for visa restrictions across the world (US, Singapore, UK). While we expect the company to suffer from the same weakness as its peers, HCLT is the only company taking the right steps (acquisitions, IP partnerships) to mitigate them. With current valuations below peers (top-4) despite highest growth expectations, we find current prices attractive from the prospect of long-term growth.

On the right track – Making amends to an inefficient capital allocation policy

Indian IT services companies have been guilty of following a highly inefficient capital allocation policy over the last decade – by sitting on cash and not investing it to secure growth (organic/inorganic). Over the last 10 years, HCLT generated Rs 269bn of OCF and paid out 34% of this cash as dividends, keeping 36% as cash/investments. In this period, it did not acquire any company of significant size/capability apart from Axon in 2008. However, in the last six months, it has made *six* acquisitions, adding ~US$ 500mn to its revenues. It finally appears to be making amends to its capital-allocation policy and is looking to invest in new-age digital-technology companies to secure future growth.

ERD: The segment with huge growth potential – going strong

HCLT is the largest Indian IT services player in the ERD domain, with revenues of US$ 1.2bn in FY16. It is also the third-largest ESO company in the world, second to Altran Technologies and Alten SA – both French companies. We are highly optimistic about the potential of the ERD domain where Indian IT companies are looking at increasing their presence, based on domain expertise developed over the last decade and an abundant supply of engineers. HCLT strengthened its presence in this domain by acquiring Geometric Ltd (US$ 135mn revenues) in April 2016 and Butler America Aerospace Ltd (US$ 85mn revenues) in October 2016. We expect ERD to significantly mitigate the impact of a slowdown in other service lines for the company (especially IMS), over the next few years.

IMS stabilising; still a long way before large-scale migration to cloud happens

The biggest concern for HCLT has been cannibalisation of IMS revenues by clients moving to cloud platforms. However, the acquisition of Volvo IT business has expanded its footprint in the European IMS market. IMS now forms 40% of HCLT's revenues, and has grown 26% for 9MFY17 (largely inorganic though). 71% of HCLT's IMS revenues come from G2000 clients – who we believe will take at least 3-5 years to migrate a significant part of their business to cloud platforms, because of their present investments in existing infrastructure (hardware, servers) and security concerns related to public cloud platforms. We believe that this client profile provides the company enough time to reinvent itself, and develop capabilities that will help it to grow, even after a large-scale migration to cloud platforms takes place.

Innovation in DNA; lean structure to help it turnaround sooner

HCLT has always had this uncanny ability to reinvent itself. It entered and expanded in the IMS business when Infosys shunned it as low-end work. It captured market share in ERD from pioneers in that domain – Wipro and TCS. Even in Europe, it was one of the first Indian IT company to open a delivery centre and look beyond UK – to Scandinavia and South European countries. We expect its innovation-laden DNA and lean structure (only 111k employees vs. TCS/Infosys/Wipro's 378k/200k/179k) to help it reinvent itself once again – and come out of the current technology disruption as a transformed company.

Outlook and Valuation

After the recent stock price correction, the stock is trading at 12x FY19 P/E – at a discount to all its large-cap peers. For FY17, the company will report CC growth of 11.0-13.0% (~8.0-8.5% organic) – highest among its peers. With growth ahead of peers and valuations behind them, we see the current price as an attractive entry point from a long-term position. We adjust our estimates to USD-INR assumption of 65 for FY18/19 (earlier 69) and roll forward our valuation to FY19. We upgrade our target multiple to 14x (earlier 13x). Our price target is Rs 910 (Rs 840 earlier). Upgrade to BUY.

BUY (Upgrade)

CMP RS 800

TARGET Rs 910 (+14%)

Sector weight: UW

COMPANY DATA

O/S SHARES (MN) :	1411
MARKET CAP (RSBN) :	1173
MARKET CAP (USDBN) :	18.1
52 - WK HI/LO (RS) :	890 / 707
LIQUIDITY 3M (USDMN) :	23.0
PAR VALUE (RS) :	2

SHARE HOLDING PATTERN, %

	Dec 16	Sep 16	Jun 16
PROMOTERS :	60.3	60.4	60.36
FII / NRI :	24.3	25.7	25.69
FI / MF :	8.0	6.7	6.57
NON PRO :	3.5	1.2	1.19
PUBLIC & OTHERS :	3.9	6.0	6.2

KEY FINANCIALS

Rs mn	FY17E	FY18E	FY19E
Net Sales	468.9	506.1	545.0
EBIDTA	103.2	110.2	116.6
Net Profit	82.5	85.4	90.5
EPS, Rs	58.4	61.3	65.0
PER, x	13.7	13.0	12.3
EV/EBIDTA, x	9.7	9.1	8.4
P/BV, x	3.5	3.5	3.1
ROE, %	25.7	26.8	25.3

Source: PhillipCapital India Research Est.

CHANGE IN ESTIMATES

	Revised Est.		% Revision	
Rs bn	FY18E	FY19E	FY18E	FY19E
Revenue ($mn)	7,786	8,385	1.2%	2.0%
EBITDA	110.2	116.6	-4.0%	-3.7%
Core PAT	85.4	90.5	-5.0%	-5.3%
EPS (Rs)	61.3	65.0	-2.6%	-3.0%

Vibhor Singhal (+ 9122 6246 4109)
vsinghal@phillipcapital.in

Shyamal Dhruve (+ 9122 6246 4110)
sdhruve@phillipcapital.in

Making amends to the inefficient capital allocation policy of the last decade

In our December 2015 report, we downgraded the IT sector to underweight. The core of our argument was that Indian IT companies have followed a highly inefficient capital allocation policy in the last decade by sitting on excessive cash instead of investing it to acquire capabilities. This will lead to the companies being sandwiched between two layers of global behemoths (Accenture, IBM) and niche start-ups in the enterprise digital space, leading to subdued topline and earnings growth over the next three years.

Read our detailed report on the inefficient capital allocation policy of the Indian IT companies ***here***

Utilisation of the OCF generated over the last decade

Rs mn	TCS	Infosys	Wipro	HCLT	Total
Revenue	53,41,604	28,95,800	28,87,561	17,38,637	1,28,63,602
OCF	8,66,621	5,81,590	4,34,505	2,68,958	21,51,674
Dividend	4,34,687	2,40,310	1,42,558	90,833	9,08,387
Capex	1,74,652	1,59,880	1,04,468	67,693	5,06,694
Cash added	1,95,216	2,85,140	1,55,643	97,991	7,33,990
Acquisitions	41,955	37,030	74,114	37,846	1,90,944
	TCS	**Infosys**	**Wipro**	**HCLT**	**Total**
Dividend Payout Ratio	36.9%	34.1%	28.7%	33.8%	34.3%
Dividend as a % of OCF	50.2%	41.3%	32.8%	33.8%	42.2%
Capex as % of OCF	20.2%	27.5%	24.0%	25.2%	23.5%
Cash added as % of OCF	22.5%	49.0%	35.8%	36.4%	34.1%
Acquisition as % of OCF	4.8%	6.4%	17.1%	14.1%	8.9%

Source: Companies, PhillipCapital India Research

HCLT appears to be the only company looking to make amends to this policy. The company has embarked on a string of partnerships and acquisitions – boosting revenue growth as well as helping the company secure 'high-end' engagements with clients. We see this as a sign of adopting an efficient capital allocation policy, providing the company with delivery capabilities and securing future growth.

HCLT has entered into three IP partnership deal with IBM, in the areas of application security, analytics, and testing automation. These deals will not only help the company report incremental growth, but also give it a chance to showcase its prowess in these domains to other clients. The deals entail a total investment of US$ 555mn and are expected to contribute US$ 115mn in annual revenues. The significance of these investments can be gauged from the fact that the company's balance sheet size has literally doubled to US$ 1.2bn in December 2016 from US$ 0.6bn in March 2016.

HCLT has been on an acquisition spree over the last year

Date	Target	Country	Business Description	Consideration ($ mn)	Revenue ($ mn)
Dec-16	IP Partnership	US	Application security, B2B data transformation, Testing automation and Mainframe management tools	155.0	50.0
Dec-16	Butler America Aerospace	US	Engineering & Design services to Aerospace and Defense customers	85.0	85.0
Sep-16	IP Partnership	US	API/web service enablement for mainframes	55.0	15.0
Jun-16	IP Partnership	US	To invest in and grow workload Automation and DevOps software of a global tech major	350.0	40.0
Apr-16	Geometric	India	PLM and engineering services	195.0	135.0
Feb-16	Volvo IT	Sweden	External IT services arm of Volvo	135.0	190.0
Jan-16	Point to Point	UK	Workplace engineering services	10.0	11.5
Nov-15	CSC	US	To operate and expand the existing Core Banking business of CSC	53.5	NA
Oct-15	PowerObjects	US	Professional services for Microsoft Dynamics CRM	41.5	37.0
Oct-15	C2SiS	India	Engineering services firm	2.0	NA
Aug-15	Trygstad Technical Services	US	Turnkey solutions for a large ISV	10.0	NA
				1092.0	**563.5**

Source: Company, PhillipCapital India Research

HCLT – inorganic and organic revenue over next two years

Total inorganic revenue (USD mn)	FY17E	FY18E	FY19E
Volvo	160	160	160
IBM-1	40	60	60
IBM-2	5	15	15
IBM-3	5	50	50
Butler	20	85	85
Geometric	10	135	135
Total	**240**	**505**	**505**
Incremental inorganic revenue (USD mn)	**FY17E**	**FY18E**	**FY19E**
Volvo	160	0	0
IBM-1	40	20	0
IBM-2	5	10	0
IBM-3	5	45	0
Butler	20	65	0
Geometric	10	125	0
Total Incremental	**240**	**265**	**0**
Total Revenue	**6,982**	**7,786**	**8,385**
Total USD revenue growth	**12.0%**	**11.5%**	**7.7%**
Organic growth	**8.1%**	**8.0%**	**8.2%**

Source: Company, PhillipCapital India Research

Most companies focusing on acquiring companies, new technology domains

	Traditional domains	New domain (ERD, Digital etc)
HCLT	Powerteam LLC, Point to Point, Volvo IT	C2SiS, Geometric, IP Partnerships (3), Butler America
Infosys	Lodestone	Panaya, Skava, Noah Consulting
TCS	None	None
Wipro	Cellent, Healthplan, InfoSERVER, Drivestream	Designit, Appirio
Cognizant	CNO Financial, Storebrand Baltic, Heliocentric, Frontica Business, Klockner Information, Nova IT	KBACE Tech, ReD Associates, Quick Left, Idea Couture, Mirabeau BV, Adaptra
Accenture	EnergyQuote JHA, Total Logistics, S3 TV Technology, Sagacious Consultants, Beacon Consulting Group, Formicary, Realworld OO Systems, Karmarama, Altitude, InvestTech Systems, Endgame	Axia, Tquila UK, Javelin Group, Brightstep, Pacifilink HK, Chaotic Moon. Solium, Schlumberger BC, AD. Daileto, FusionX, Cloud Sherpas, Cimation, Boomerang Pharma, CRMWaypoint, IMJ Corp, OPS Rules, Maglan Info, dgroup, MOBGEN, Tecnilogica, Redcore, New Energy Group, Kurt Salmon, DayNine, Defense Point, Allen, 2nd Road, Nashco, solid-serVision.com

Source: Companies, PhillipCapital India Research

Buyback: A step in the right direction, but continuity is the key

On 20th March 2017, HCLT announced a buyback of its equity shares under which it will buy back up to 35mn shares (2.5% of its current paid-up equity shares) at Rs 1,000 for an aggregate amount of Rs 35bn (13.6% of consolidated share capital and free reserves) though a tender offer.

HCLT buyback details

Buy-back no of shares (mn)	35
Total shares (mn)	1,412
Buy-back as % of Total shares	2.5%
Buy-back Price (Rs)	1,000
CMP (Rs) – on announcement date	863
Premium %	15.9%
Buy-back size (Rs bn)	**35**
FY18E EPS (Pre-buyback) (Rs)	60.7
FY18E EPS (Post-buyback) (Rs)	61.3
Impact on FY18E EPS %	1.1%

Source: Company, PhillipCapital India Research

We believe that these buybacks (TCS also announced one) do not provide much value to shareholders if they remain sporadic, which appears to be the case right now. Just like TCS' buyback will provide a tender rate of only 3%, HCLT's buyback will benefit only 2.5% of shareholders. We would rather have the company announce a long-term capital allocation policy akin to Cognizant and Infosys' announcements.

IMS business is stabilising

The biggest concern for HCLT has been the cannibalisation of IMS revenues by clients moving to cloud platforms. With cloud server providers like AWS and MS-Azure already offering basic infrastructure services with the cloud platform and expanding to include application development platforms, HCLT faced revenue deceleration in the IMS segment in FY16.

HCLT's growth in IMS has slowed down over the last three years

	FY14	FY15	FY16
IMS ($mn)			
HCLT	1,721	2,007	2,216
TCS	1,603	2,135	2,474
Infosys	584	699	772
Wipro	1,590	1,917	2,075
IMS (% yoy)			
HCLT	37.9%	16.6%	10.4%
TCS	20.8%	33.2%	15.9%
Infosys	14.7%	19.8%	10.4%
Wipro	8.6%	20.6%	8.2%

Source: Companies, PhillipCapital India Research

However, the acquisition of Volvo's IT business has expanded HCLT's footprint in the European IMS market. IMS now forms 40% of HCLT's revenues and has grown 26% for 9MFY17, though driven by the organic route.

The Volvo deal has helped HCLT report strong IMS growth over the last 3 quarters

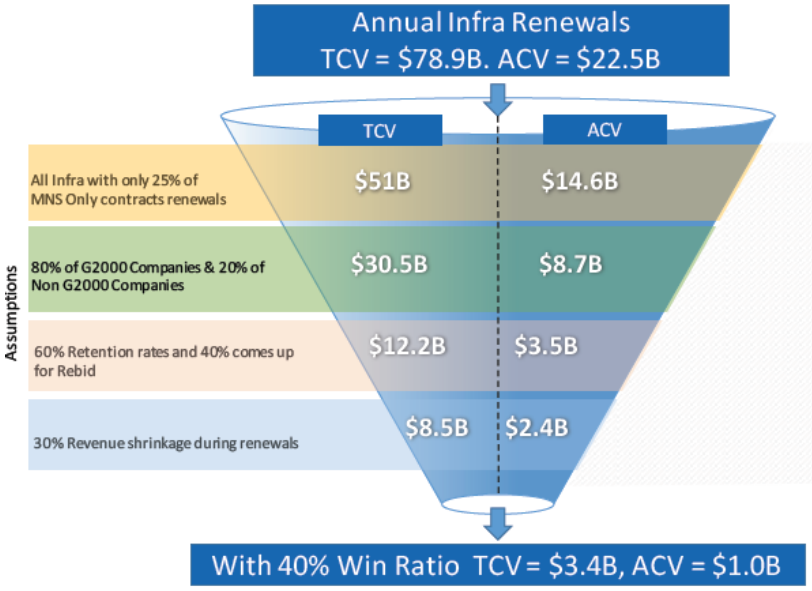
IMS ($mn)	1QFY16	2QFY16	3QFY16	4QFY16	1QFY17	2QFY17	3QFY17
HCLT	543	542	556	575	673	694	695
TCS	593	611	630	639	676	687	737
Infosys	187	208	181	196	208	217	219
Wipro	502	513	517	544	539	540	535
IMS (% yoy)	**1QFY16**	**2QFY16**	**3QFY16**	**4QFY16**	**1QFY17**	**2QFY17**	**3QFY17**
HCLT	11.9%	9.7%	8.4%	11.7%	23.9%	28.0%	24.9%
TCS	27.5%	12.7%	12.1%	13.1%	14.0%	12.4%	17.0%
Infosys	11.1%	19.7%	-0.7%	11.9%	10.9%	4.4%	21.5%
Wipro	13.2%	6.5%	3.9%	9.9%	7.2%	5.4%	3.5%

Source: Companies, PhillipCapital India Research

HCLT currently employs 34,000+ employees in IMS, catering to 249 customers across 31 countries. It has built significant capabilities in this space and invested heavily for capturing growth. This is evident from its performance over the last three years, where it grabbed market share in the domain, not only from Indian IT companies, but also MNCs like IBM.

The management sees huge opportunity from the IMS deals coming up for renewal over the next three years. From the US$ 79bn of 'Annual IMS renewals', it expects a TCV of at least US$ 3.4bn, assuming a conservative win ratio of 40%, retention of incumbent vendor at 60%, and 30% revenue shrinkage during renewal. We believe that if the company manages to achieve this annual TCV (US$ 3.4bn) for the next 2-3 years, it will be able to more than mitigate the impact of losing existing business to new players and/or migration of clients to the cloud platform.

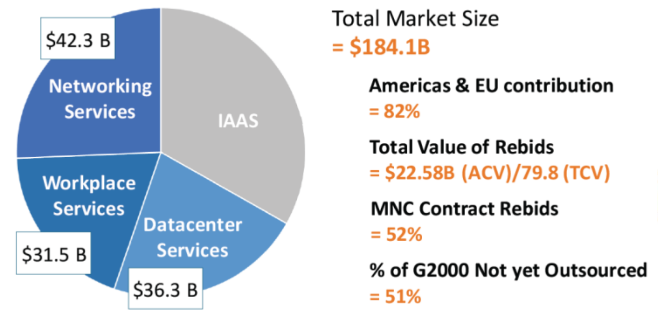
HCLT sees tremendous opportunity from IMS deal renewals



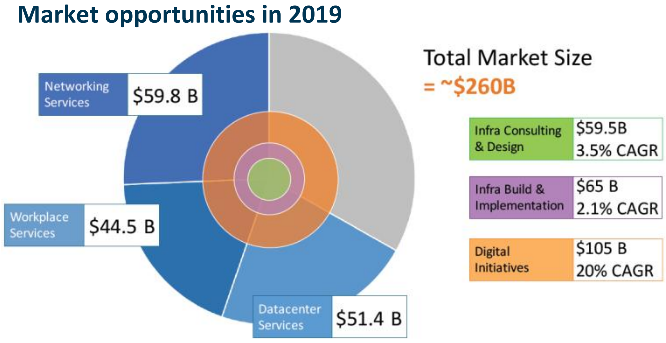
Source: Company

Data center service, which has been impacted by cloud migration, is 40% of the IMS revenue for HCLT, while the remaining 60% comes from Network and Workplace services – which management feels would not be impacted by cloud migration. With the increase in outsourcing adoption by G-2000 companies (51% still not outsourced), the management expects tremendous market opportunities in the next few years.

IMS addressable market in 2016



Market opportunities in 2019



Source: Company

G2000 clients – still a long way to go for cloud migration

HCLT derives 52% of IMS revenue from top-26 customers while G-2000 customers constitute 71% of IMS revenue. We believe that these G-2000 customers, who have already invested heavily into their hardware and servers, will take time (at least three to five years) to migrate a significant part of their business to cloud platforms. While part adoption is already in progress, the pace of adoption will also depend on how soon the industry is able to address security concerns related to public cloud platforms.

We trust the HCLT management to be able to see what we can see – and expect it to formulate a strategy for the inevitable. With 71% of the IMS business coming from G2000 clients, the company has enough time to reinvent itself, and develop capabilities, which would prevent it from becoming irrelevant, after large-scale adoption of cloud platforms takes place.

Engineering Research & Design (ERD): Huge growth potential

Over the last decade, Indian IT services companies have developed significant capabilities and domain expertise in ERD. Top-4 IT services companies have reported a CAGR of 12% over the last five years in this domain (14% excluding Wipro) – higher than the overall industry growth.

Read our detailed report on the potential of the ERD segment ***here***

HCLT closing in, on the top ERD outsourcing companies in the world

	Country	Market Cap (US$ bn)	ERD Revenue (US$ bn)
Altran Technologies	France	2.5	2.2
Alten SA	France	2.1	1.8
HCLT	India	17.7	1.2

Source: Company, PhillipCapital India Research

HCLT has outpaced its peers in the ERD space

ERD (US$ mn)	FY11	FY12	FY13	FY14	FY15	FY16	CAGR	% of Revs
TCS	395	473	535	632	699	753	14%	5%
Infosys	340	325	370	433	459	470	7%	5%
HCLT	510	644	774	821	881	1,172	18%	19%
Wipro	443	493	492	478	506	580	6%	8%
Total top-4	**1,688**	**1,935**	**2,172**	**2,364**	**2,546**	**2,976**	**12%**	**8%**

Source: Companies, PhillipCapital India Research

HCLT has done particularly well in ERD, capturing market share not only form Indian IT companies, but also global competitors. The company snatched the first mover advantage in this domain from Wipro and TCS, and has grown by a CAGR of 19% over the last six years, to become the largest Indian and third-largest global ESO player. HCLT has significant domain knowledge of avionics, auto, and electronics – and is continuously expanding it to other domains.

Not shy of taking the inorganic route

In April 2016, HCLT announced the acquisition of Geometric Ltd, a provider of engineering services and PLM solutions. The acquisition gave it access to Geometric Ltd's 60 clients (ABB, Boston Gear, Daimler Chrysler, Honda R&D, Siemens) and a highly trained workforce of 4,800 employees. We expect significant synergies from the acquisition with minimum client overlap, and the opportunity to cross-sell its ERD expertise to those clients. Geometric reported revenues of US$ 188mn and EBIT margin of 11.7% in FY16. We expect the acquisition to be marginally EPS dilutive (-0.6%).

In October 2016, HCLT announced another acquisition in the ERD space – Butler America Aerospace. Butler provides engineering (mechanical and structural design, electrical and tool design and aftermarket engineering services) and design services to US aerospace and defence customers. HCLT added 900 highly engineers, through this acquisition, to its force. Butler Aerospace reported revenues of US$ 85.4mn and EBIT of 12.2%. We expect the acquisition to be marginally EPS dilutive (-0.3%).

Geometric and Butler acquisitions to boost HCLT's ERD business

	Geometric	Butler
Business Segment	ER&D	ER&D
FY16 Revenue ($mn)	188	85
EBIT %	11.7	12.2
No of Employees	4,800	900
Key Clients	ABB, Boston Gear, Daimler Chrysler, Honda R&D, Siemens	Several aerospace and defense customers in US

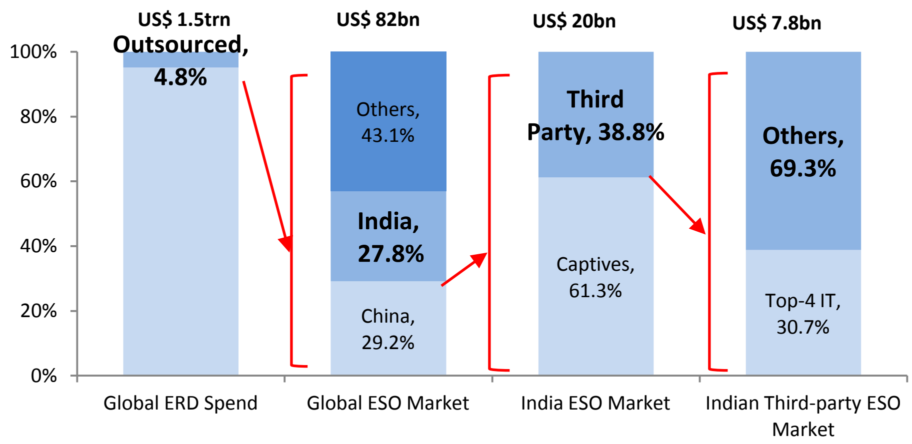
Source: Company, PhillipCapital India Research

Global ERD industry: Huge growth potential

In CY15, global ERD spend grew by ~3% to US$ 1.5tn. Automotive and consumer electronics sectors accounted for over 25% of this spend—automotive driven by safety and emission-efficiency requirements and consumer electronics by increasing demand for new products/interfaces. US and Europe continued to account for over 2/3rd of this spend, with Asia (excluding Japan) constituting 14% and growing fast.

Currently, the engineering services outsourcing (ESO) market stands at US$ 72bn – only 5% of the total global ERD spend. Of this, China accounts for the largest share (29%), driven by its manufacturing industry. India comes a close second at 28%, driven primarily by the captives (61%) and third-party outsourcers (39%). Of the third-party outsourcers, the top-4 IT services companies have almost 40% market share.

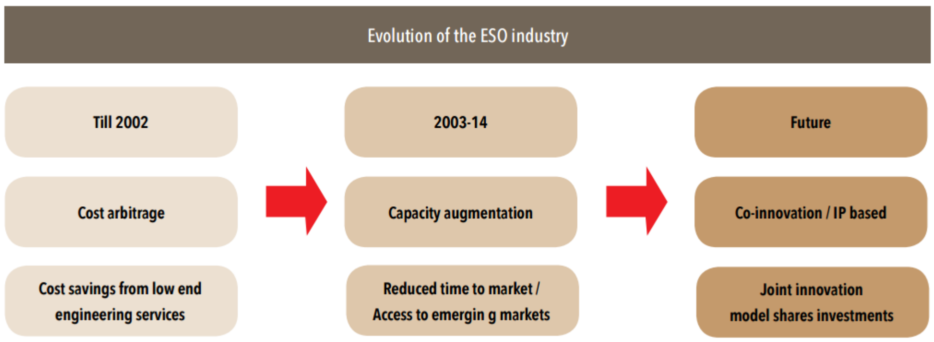
The global ERD-ESO market



Source: NASSCOM, Zinnov, PhillipCapital India Research

Historically, most global engineering companies have been reluctant to outsource their R&D – because of obvious concerns of intellectual property theft and perception of inferior capabilities of the Indian companies. However, over the last two decades, we have seen a significant increase in the ERD outsourcing deals – with new client joining the bandwagon and existing clients outsourcing larger and more strategic shares of their ERD work.

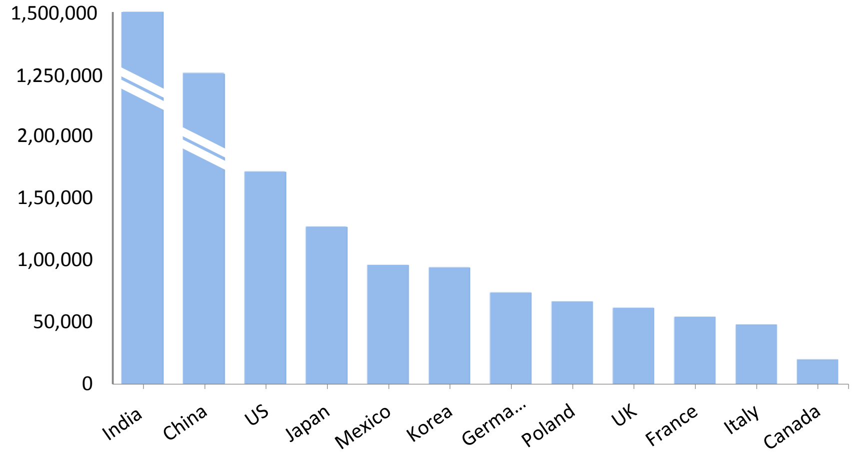
Evolution of the ESO industry



Source: PhillipCapital India Research

Indian IT services companies are now able to contribute more to the client than just being a relatively inexpensive alternative. What works in their favour is the abundant pool of engineers, which the country produces every year. ERD, being a highly technical domain, requires engineers trained on specific CAD/CAM platforms, as against an IT graduate for traditional IT services contracts.

India accounts for the largest pool of engineers graduating every year



Source: OECD, AICTE, PhillipCapital India Research

Poles apart – ERD and other traditional IT service lines

Parameter	Traditional service lines	Engineering research and design
Educational/technical qualification of the 'developer'	Software developers	Engineers—preferably Mechanical/Electrical
Training to be imparted to the 'developer' before induction	Various software platforms like Java, .net, C++	Various engineering design platforms like CATIA, SolidWorks, Pro/E
Nature of project deliverable	Customised software solution, with post-delivery maintenance	Parts of the Product Life-cycle Management (PLM), that can be integrated with various such deliverables from across the globe
Failure risk	Medium - Problems in the deliverable can be fixed in post-delivery maintenance period	High - Problems in deliverable can lead to faulty product design for the client; can lead to potential loss of client
Major verticals	BFSI, manufacturing, telecom - across the spectrum	Manufacturing - auto, aerospace, consumer electronics; healthcare - medical devices
Project duration	Medium to long: varying from 2- 7 years (for IMS)	Short: Less than 12-18 months

Source: PhillipCapital India Research

Key ESOs in each vertical

	Automotive	Aerospace	Energy & Utilities	Consumer Electronics
Captives	Bosch	Airbus	Shell	Samsung
	Daimler	Honeywell	Petrofac	LG
	Ford		Schlumberger	Phillips
Third party	KPIT	Cyient	Wipro	TCS
	Infosys	HCLT	Quest	MindTree
	Tata Technologies	Tech Mahindra	Geometric	HCLT
		TCS	Aker Solutions	Tata Elxsi

Key strengths of the key companies

TCS	Infosys	HCLT	Wipro	Tech Mahindra
All sectors - Auto/Aero/Consumer Electronics	Overall weak presence - mainly Aerospace	Avionics	Medical devices	Product design
Geometric Ltd	**Quest**	**Cap Gemini**	**IBM**	**Accenture**
Product Lifecycle management	After sales - esp for aerospace	Technical Publication / Documentation	Process Consultation / PLM implementation	Process Consultation / PLM implementation

Source: PhillipCapital India Research

In the wake of shrinking deal sizes in the traditional IT services domain and cannibalisation of revenues by new-age digital platforms like cloud and analytics, we expect ERD to provide some respite to Indian IT services companies, especially HCLT. At 18% of revenues, ERD can provide the cushion that the company needs to continue reporting decent growth, while its traditional streams are cannibalised by new-age digital technologies.

Set to be the fastest growing large-cap in Indian IT

HCLT underperformed its large-cap peers over FY15-16 in terms of revenue growth due to a slowdown in the IMS business and absence of inorganic revenue. However, with the acquisitions of Volvo IT and IP partnership deals with IBM, in FY17, we expect HCLT to report highest USD revenue growth amongst its peers. In FY18, too, we expect HCLT to report industry-leading growth of 11%, driven by Geometric/Butler acquisitions and superior organic revenue growth.

HCLT is set to outperform all its peers – even global MNCs like Accenture

	FY15	FY16	FY17E	FY18E	FY19E
HCLT	12.4%	7.1%	12.0%	11.0%	8.0%
TCS#	15.0%	7.1%	6.2%	6.9%	6.9%
Infosys#	5.6%	9.1%	7.4%	7.6%	8.8%
Wipro#	7.0%	3.7%	4.9%	4.4%	5.9%
TechM	18.3%	10.2%	7.7%	7.0%	6.9%
Cognizant*	16.1%	21.0%	9.1%	8.9%	NA
Accenture*	3.5%	5.9%	6.9%	5.8%	NA

Source: Companies, PhillipCapital India Research; * Bloomberg estimates for FY17-18E; # Actual numbers for FY17

HCLT has the lowest number of employees among the top-5 Indian IT companies, with highest employee productivity. We believe that this lean structure will help HCLT 'turn-around' sooner and re-invent its business model faster than its peers.

HCLT has the leanest structure among large-caps

Dec 2016	Employees	TTM Rev ($mn)	Rev/Employee ($'000)
HCLT	111,092	6,746	60.7
TCS	378,497	17,330	45.8
Infosys	199,763	10,085	50.5
Wipro	179,129	8,064	45.0
TechM	117,095	4,243	36.2

Source: Companies, PhillipCapital India Research

Visa proposal to have lowest impact – relatively

Various proposals related to visa restrictions have been introduced in the US Congress – the most recent one proposes to increase the minimum wage bill for H1B visa holders to US$ 130,000 from the current US$ 60,000. If implemented, this move will affect all IT companies. However, HCLT would be the least impacted compared to its peers, as locals make up 65% of its US workforce, while the rest are on H1B visas. Also, HCLT's average annual salary for its H1B visa holder employees is around US$ 80,000, higher than current minimum salary norms and peers.

HCLT to have minimum impact of US visa regulations

	Particular	TCS	Infosys	HCLT	TechM
	H1B Employees	25,000	14,659	3,780	3,000
	Avg Annual Salary of H1B ($)	69,700	79,000	80,000	75,000
	Per Year Impact (Rs mn)	26,140	11,582	3,215	2,805
FY19	Revenue (Rs mn)	1,304,710	777,290	545,021	342,754
	EBITDA (Rs mn)	342,453	210,026	116,559	55,803
	EBITDA Margin (%)	26.2%	27.0%	21.4%	16.3%
	PAT (Rs mn)	273,249	161,112	90,531	36,674
	EPS (Rs)	142.8	70.5	65.0	41.9
FY19 - New	EBITDA (Rs mn)	316,313	198,445	113,345	52,998
	EBITDA Margin (%)	24.2%	25.5%	20.8%	15.5%
	PAT (Rs mn)	247,108	149,530	87,316	33,869
	EPS (Rs)	129.1	65.4	62.7	38.7
Deviation	EBITDA (%)	-7.6%	-5.5%	-2.8%	-5.0%
	Margin (bps)	(200)	(149)	(59)	(82)
	PAT (%)	-9.6%	-7.2%	-3.6%	-7.6%

Source: PhillipCapital India Research

Valuations

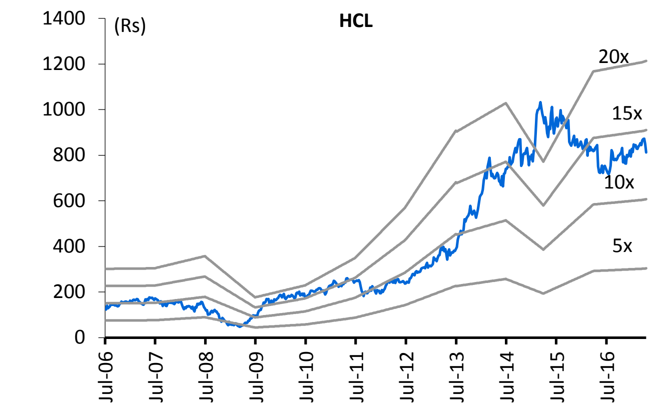
HCLT has traditionally traded at a discount to its large-cap peers – especially TCS and Infosys, mainly because of its historically low margins and cash-flow generation. However, over the last few years, it has expanded its margins (550bps over FY11-17) and improved OCF generation too. This period also saw the stock rerate to 13.5x one-year forward P/E from 11x earlier.

Currently, HCLT is trading at 12x FY19 P/E – a discount to all its peers (large-caps). For FY17, the company will report CC growth of 11.0-13.0% (~8.0-8.5% organic) – highest among its large-cap peers. In FY18/19, too, we expect HCLT to report superior growth to all large-caps. With growth ahead of peers and valuations behind them, we see the current price as an attractive entry point from the prospect of long-term growth.

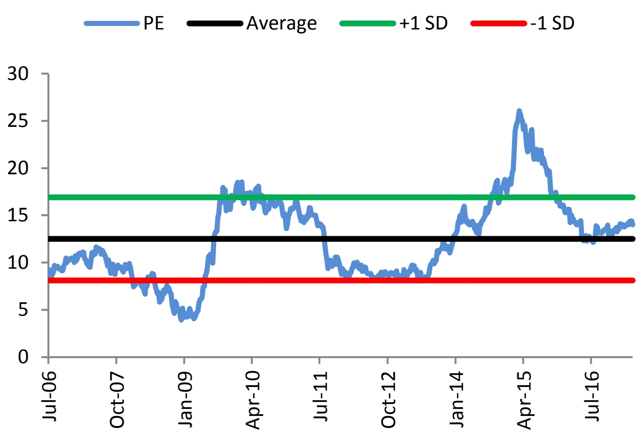
Recommendations summary

	CMP	Mkt Cap	Target	PT	Upside	Rating	USD Rev	Growth	EPS (Rs)		P/E	
	Rs	Rs bn	Multiple	Rs	%		FY18E	FY19E	FY18E	FY19E	FY18E	FY19E
TCS	2,310	4,552	14.0	2,000	-13%	SELL	6.9	6.9	138	143	17	16
Infosys	914	2,089	15.0	1,060	16%	BUY	7.6	8.8	64	70	14	13
Wipro	490	1,206	11.0	410	-16%	SELL	3.7	5.4	35	37	14	13
HCL Tech	800	1,130	14.0	910	14%	BUY	11.5	7.7	61	65	13	12
Tech Mahindra	425	368	12.0	475	12%	NEUTRAL	6.6	6.9	38	42	11	10
MindTree	476	80	12.0	400	-16%	SELL	8.8	8.4	29	33	16	14
Persistent	582	47	12.0	530	-9%	SELL	7.9	7.5	41	44	14	13
KPIT	130	24	9.0	120	-9%	SELL	5.2	5.3	13	14	10	9
NIIT Tech	456	28	10.0	500	19%	BUY	6.2	7.2	49	54	9	8

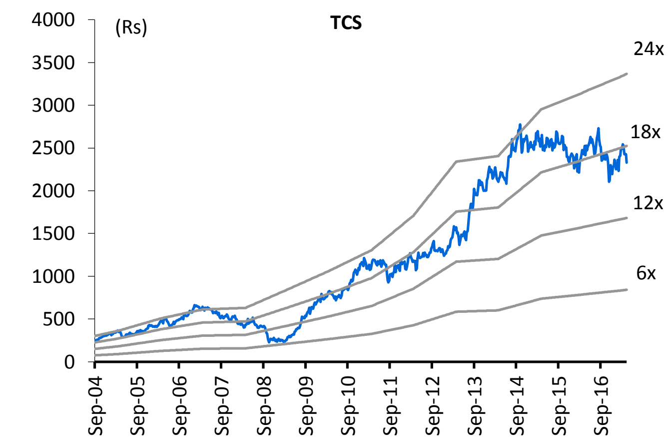
HCLT PE band



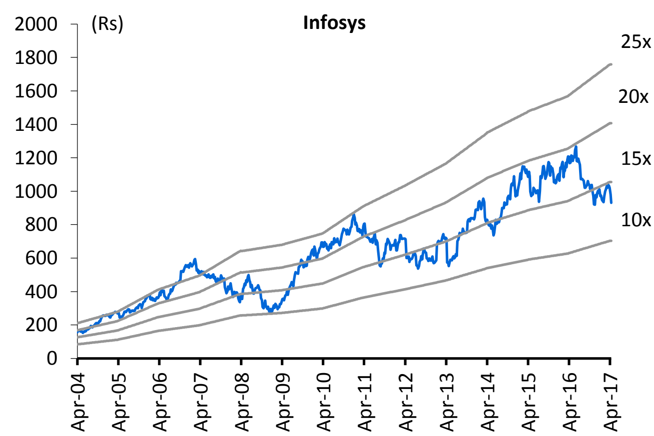
HCLT PE – Standard Deviation



TCS PE band



Infosys PE band



Source: PhillipCapital India Research

Financials

Income Statement

Y/E June, Rs mn	FY16	FY17E	FY18E	FY19E
Net sales	**311,360**	**468,896**	**506,086**	**545,021**
Growth, %	-16	51	8	8
Employee expenses	-204,710	-309,496	-335,944	-364,158
Other Operating expenses	-39,690	-56,157	-59,916	-64,304
EBITDA (Core)	**66,960**	**103,243**	**110,226**	**116,559**
Growth, %	(23.1)	54.2	6.8	5.7
Margin, %	21.5	22.0	21.8	21.4
Depreciation	-4,450	-8,234	-9,320	-9,769
EBIT	**62,510**	**95,009**	**100,907**	**106,790**
Growth, %	(24.2)	52.0	6.2	5.8
Margin, %	20.1	20.3	19.9	19.6
Other Non-Operating Income	6,630	7,839	7,915	8,536
Forex Gains\ (Losses)	370	1,893	0	0
Pre-tax profit	**69,510**	**104,742**	**108,821**	**115,326**
Tax provided	-14,990	-22,287	-23,397	-24,795
Profit after tax	**54,520**	**82,455**	**85,425**	**90,531**
Non Recurring Item	0	0	0	0
Net Profit	**54,520**	**82,455**	**85,425**	**90,531**
Growth, %	(24.9)	51.2	3.6	6.0
Net Profit (adjusted)	**54,520**	**82,455**	**85,425**	**90,531**
Wtd avg shares (m)	1,412	1,413	1,393	1,393

	FY16	FY17E	FY18E	FY19E
US$ Revenue ($ mn)	**6,236**	**6,982**	**7,786**	**8,385**
Growth, %	7.1	12.0	11.5	7.7
Re / US$ (rate)	66.3	67.2	65.0	65.0

Balance Sheet

Y/E June, Rs mn	FY16	FY17E	FY18E	FY19E
Cash & bank	7,293	39,867	11,090	35,371
Marketable securities at cost	111,236	108,419	118,419	128,419
Debtors	107,228	109,195	117,856	126,923
Inventory	0	0	0	0
Other current assets	24,102	28,107	30,237	32,042
Total current assets	249,859	285,589	277,602	322,755
Investments	1,601	1,473	1,473	1,473
Net fixed assets	146,213	173,463	191,023	196,059
Non-current assets	0	0	0	0
Total assets	**397,673**	**460,524**	**470,098**	**520,287**
Total current liabilities	95,085	118,711	128,855	139,677
Non-current liabilities	22,367	20,851	21,962	22,904
Total liabilities	117,452	139,562	150,817	162,581
Paid-up capital	1,413	1,412	1,393	1,393
Reserves & surplus	278,808	319,550	317,888	356,313
Minorities	0	0	0	0
Shareholders' equity	280,221	320,963	319,281	357,706
Total equity & liabilities	**397,673**	**460,524**	**470,098**	**520,287**

Source: Company, PhillipCapital India Research Estimates

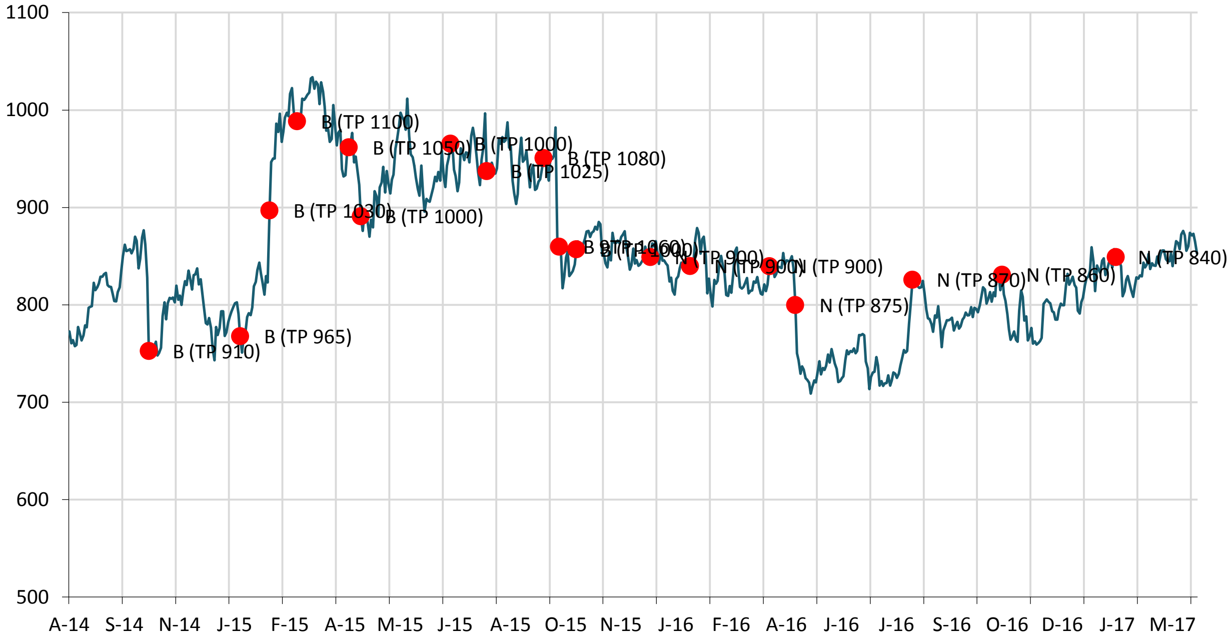
Cash Flow

Y/E June, Rs mn	FY16	FY17E	FY18E	FY19E
Pre-tax profit	69,510	104,742	108,821	115,326
Depreciation	4,450	8,234	9,320	9,769
Chg in working capital	-10,325	17,653	-646	-50
Total tax paid	-14,990	-22,287	-23,397	-24,795
Other operating activities	0	0	0	0
Cash flow from operating activities	**48,645**	**108,342**	**94,098**	**100,250**
Capital expenditure	-29,763	-35,483	-26,880	-14,805
Chg in investments	-1,521	128	0	0
Chg in marketable securities	-6,866	2,817	-10,000	-10,000
Other investing activities	0	0	0	0
Cash flow from investing activities	**-38,150**	**-32,538**	**-36,880**	**-24,805**
Free cash flow	10,495	75,804	57,218	75,445
Equity raised/(repaid)	0	-1	-19	0
Debt raised/(repaid)	5,087	-1,516	1,111	942
Dividend (incl. tax)	-29,648	-39,611	-52,106	-52,106
Other financing activities	7,839	-2,102	-34,981	0
Cash flow from financing activities	**-16,722**	**-43,230**	**-85,995**	**-51,164**
Net chg in cash	-6,227	32,574	-28,777	24,280

Valuation Ratios

	FY16	FY17E	FY18E	FY19E
Per Share data				
EPS (INR)	38.6	58.4	61.3	65.0
Growth, %	(24.9)	51.2	5.1	6.0
Book NAV/share (INR)	198.4	227.2	229.2	256.8
CFPS (INR)	29.7	71.2	61.9	65.8
DPS (INR)	17.9	24.0	32.0	32.0
Return ratios				
Return on assets (%)	14.4	19.2	18.4	18.3
Return on equity (%)	19.5	25.7	26.8	25.3
Return on capital employed (%)	19.2	25.6	25.0	25.1
Turnover ratios				
Asset turnover (x)	1.9	2.5	2.5	2.6
Sales/Total assets (x)	0.8	1.1	1.1	1.1
Sales/Net FA (x)	2.3	2.9	2.8	2.8
Working capital/Sales (x)	0.1	0.0	0.0	0.0
Receivable days	125.7	85.0	85.0	85.0
Liquidity ratios				
Current ratio (x)	2.6	2.4	2.2	2.3
Quick ratio (x)	2.6	2.4	2.2	2.3
Dividend cover (x)	2.2	2.4	1.9	2.0
Total debt/Equity (%)	8.0	6.5	6.9	6.4
Net debt/Equity (%)	5.4	(5.9)	3.4	(3.5)
Valuation				
PER (x)	20.7	13.7	13.0	12.3
PEG (x) - y-o-y growth	(0.8)	0.3	2.6	2.1
Price/Book (x)	4.0	3.5	3.5	3.1
Yield (%)	2.2	3.0	4.0	4.0
EV/Net sales (x)	3.3	2.1	2.0	1.8
EV/EBITDA (x)	15.4	9.7	9.1	8.4
EV/EBIT (x)	16.5	10.6	10.0	9.1

Stock Price, Price Target and Rating History



Rating Methodology

We rate stock on absolute return basis. Our target price for the stocks has an investment horizon of one year.

Rating	Criteria	Definition
BUY	>= +15%	Target price is equal to or more than 15% of current market price
NEUTRAL	-15% > to < +15%	Target price is less than +15% but more than -15%
SELL	<= -15%	Target price is less than or equal to -15%.

Management

Vineet Bhatnagar (Managing Director)	(91 22) 2483 1919
Kinshuk Bharti Tiwari (Head – Institutional Equity)	(91 22) 6246 4101
Jignesh Shah (Head – Equity Derivatives)	(91 22) 6667 9735

Research

Automobiles
Dhawal Doshi (9122) 6246 4128
Nitesh Sharma, CFA (9122) 6246 4126

Banking, NBFCs
Manish Agarwalla (9122) 6246 4125
Pradeep Agrawal (9122) 6246 4113
Paresh Jain (9122) 6246 4114

Consumer & Retail
Naveen Kulkarni, CFA, FRM (9122) 6246 4122
Jubil Jain (9122) 6246 4117
Preeyam Tolia (9122) 6246 4129

Cement
Vaibhav Agarwal (9122) 6246 4124

Economics
Anjali Verma (9122) 6246 4115
Shruti Bajpai (9122) 6246 4135

Engineering, Capital Goods
Jonas Bhutta (9122) 6246 4119
Vikram Rawat (9122) 6246 4120

IT Services
Vibhor Singhal (9122) 6246 4109
Shyamal Dhruve (9122) 6246 4110

Infrastructure
Vibhor Singhal (9122) 6246 4109

Logistics, Transportation & Midcap
Vikram Suryavanshi (9122) 6246 4111

Media
Manoj Behera (9122) 6246 4118

Metals
Dhawal Doshi (9122) 6246 4128
Yash Doshi (9122) 6246 4127

Mid-Caps & Database Manager
Deepak Agarwal (9122) 6246 4112

Oil & Gas
Sabri Hazarika (9122) 6667 9756

Pharma & Specialty Chem
Surya Patra (9122) 6246 4121
Mehul Sheth (9122) 6246 4123

Strategy
Naveen Kulkarni, CFA, FRM (9122) 6246 4122
Aashima Mutneja, CFA (9122) 6667 9764

Telecom
Naveen Kulkarni, CFA, FRM (9122) 6246 4122
Manoj Behera (9122) 6246 4118

Technicals
Subodh Gupta, CMT (9122) 6246 4136

Production Manager
Ganesh Deorukhkar (9122) 6667 9966

Editor
Roshan Sony 98199 72726

Sr. Manager – Equities Support
Rosie Ferns (9122) 6667 9971

Sales & Distribution

Ashvin Patil (9122) 6246 4105
Shubhangi Agrawal (9122) 6246 4103
Kishor Binwal (9122) 6246 4106
Bhavin Shah (9122) 6246 4102
Ashka Mehta Gulati (9122) 6246 4108
Archan Vyas (9122) 6246 4107

Sales Trader
Dilesh Doshi (9122) 6667 9747
Suniil Pandit (9122) 6667 9745

Execution
Mayur Shah (9122) 6667 9945

Corporate Communications

Zarine Damania (9122) 6667 9976

Contact Information (Regional Member Companies)

SINGAPORE: **Phillip Securities Pte Ltd**
250 North Bridge Road, #06-00 RafflesCityTower,
Singapore 179101
Tel : (65) 6533 6001 Fax: (65) 6535 3834
www.phillip.com.sg

JAPAN: **Phillip Securities Japan, Ltd**
4-2 Nihonbashi Kabutocho, Chuo-ku
Tokyo 103-0026
Tel: (81) 3 3666 2101 Fax: (81) 3 3664 0141
www.phillip.co.jp

THAILAND: **Phillip Securities (Thailand) Public Co. Ltd.**
15th Floor, VorawatBuilding, 849 Silom Road,
Silom, Bangrak, Bangkok 10500 Thailand
Tel (66) 2 2268 0999 Fax: (66) 2 2268 0921
www.phillip.co.th

UNITED STATES: **Phillip Futures Inc.**
141 W Jackson Blvd Ste 3050
The Chicago Board of TradeBuilding
Chicago, IL 60604 USA
Tel (1) 312 356 9000 Fax: (1) 312 356 9005

MALAYSIA: **Phillip Capital Management Sdn Bhd**
B-3-6 Block B Level 3, Megan Avenue II,
No. 12, Jalan Yap Kwan Seng, 50450 Kuala Lumpur
Tel (60) 3 2162 8841 Fax (60) 3 2166 5099
www.poems.com.my

INDONESIA: **PT Phillip Securities Indonesia**
ANZTower Level 23B, Jl Jend Sudirman Kav 33A,
Jakarta 10220, Indonesia
Tel (62) 21 5790 0800 Fax: (62) 21 5790 0809
www.phillip.co.id

FRANCE: **King & Shaxson Capital Ltd.**
3rd Floor, 35 Rue de la Bienfaisance
75008 Paris France
Tel (33) 1 4563 3100 Fax : (33) 1 4563 6017
www.kingandshaxson.com

AUSTRALIA: **PhillipCapital Australia**
Level 10, 330 Collins Street
Melbourne, VIC 3000, Australia
Tel: (61) 3 8633 9800 Fax: (61) 3 8633 9899
www.phillipcapital.com.au

HONG KONG: **Phillip Securities (HK) Ltd**
11/F United Centre 95 Queensway Hong Kong
Tel (852) 2277 6600 Fax: (852) 2868 5307
www.phillip.com.hk

CHINA: **Phillip Financial Advisory (Shanghai) Co. Ltd.**
No 550 Yan An East Road, OceanTower Unit 2318
Shanghai 200 001
Tel (86) 21 5169 9200 Fax: (86) 21 6351 2940
www.phillip.com.cn

UNITED KINGDOM: **King & Shaxson Ltd.**
6th Floor, Candlewick House, 120 Cannon Street
London, EC4N 6AS
Tel (44) 20 7929 5300 Fax: (44) 20 7283 6835
www.kingandshaxson.com

SRI LANKA: **Asha Phillip Securities Limited**
Level 4, Millennium House, 46/58 Navam Mawatha,
Colombo 2, Sri Lanka
Tel: (94) 11 2429 100 Fax: (94) 11 2429 199
www.ashaphillip.net/home.htm

INDIA
PhillipCapital (India) Private Limited
No. 1, 18th Floor, Urmi Estate, 95 Ganpatrao Kadam Marg, Lower Parel West, Mumbai 400013 Tel: (9122) 2300 2999 Fax: (9122) 6667 9955 www.phillipcapital.in

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PhillipCapital (India) Pvt. Ltd.

Registered office: No. 1, 18th Floor, Urmi Estate, 95 Ganpatrao Kadam Marg, Lower Parel West, Mumbai 400013

Vibhor Singhal

Digitally signed by Vibhor Singhal
DN: c=IN, o=Personal,
pseudonym=b953701ae74349b9a6d1dcdb70bc0
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cn=Vibhor Singhal
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