

Challenger emerges for a winner's curse

ACCUMULATE

Price	Target Price
Rs213	Rs 297
Sensex	13,102

Price Performance

(%)	1M	3M	6M	12M
Absolute	(7)	(22)	(22)	(30)
Rel. to Sensex	1	(15)	(2)	(9)

Source: Capitaline

Stock Details

Sector	IT Services
Reuters	HCLT.BO
Bloomberg	HCLT@IN
Equity Capital(Rs mn)	1337
Face Value(Rs)	2
52 Week H/L	336/175
Market Cap(Rs bn)	142/3,050
Daily Avg Volume (No of shares)	918420
Daily Avg Turnover (US\$)	4.5

Shareholding Pattern (%)

(30 th June'08)	
Promoters	67.5
FII/NRI	20.6
Institutions	5.0
Private Corp.	2.5
Public	4.3

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Event: HCL Tech joins the race for Axon

HCL Tech announced a formal bid to acquire Axon Group PLC post market hours on Friday, September 26'08 at £441.4 mn (~£ 6.50/share) which is at 8.3% premium to Infosys's offer for Axon. Post HCL Tech making its intention open, Infosys has 60 hours to revise its bid price for Axon (expected to get over by Monday morning IST). HCL Tech intends to fund the acquisition through a higher component of debt (company has tied up debt funding of GBP 400 mn) along with internal cash use of ~GBP 41 mn. We estimate that although Axon could be a prized asset for Axon in many ways in the form of both expanding its European/ Enterprise Apps footprint, it could be both margin/earnings dilutive over the next 2 years. Further HCL Tech could face a bigger challenge as compared with Infosys in retaining key employees. Our negative inclination could increase further if Infosys puts in a counter bid and raise the stakes for Axon buyout given growth/margin pressures for Axon. (please refer to section below) and we believe that ***probably Axon could be a winner's curse*** for whosoever gets it finally

Axon could be a more prized asset for HCL Tech

We had highlighted earlier as well that Axon could be a more prized asset for HCL Tech as compared to Infosys given that the company has lagged behind peers in the Enterprise Applications space (HCL Tech's revenues from EAS space at ~US\$ 200 p.a as compared with ~US\$ 1bn for both Infosys and Satyam, revenues have grown at 26% CAGR over FY06-08 lower than company average of ~38% over the same period) and thus could close out the gap with Axon in its fold. We add that SAP, Oracle implementation continue to be strong growth areas (similar sentiment echoed by recently released by Accenture's FY08 results as well) despite street/investor concerns/worries on a slack in overall demand for the segment.

Revenues, Package Impl. (US\$ mn)	Mar'07	Jun'07	Sep'07	Dec'07	Mar'08	Jun'08
Infosys(in US\$ mn)	195.9	216.2	241.2	260.2	275.2	273.7
Infosys QoQ growth, %	12.6%	10.4%	11.5%	7.9%	5.8%	-0.5%
Satyam (in US\$ mn)	159.0	184.9	210.6	233.6	255.3	257.9
Satyam QoQ growth, %	9.7%	16.3%	13.9%	10.9%	9.3%	1.0%
TCS (in US\$ mn)	131	143	164	179	189	181
TCS QoQ growth, %	10.5%	9.1%	14.5%	9.4%	5.3%	-4.1%
HCL Tech (in US\$ mn)	47.8	47.5	50.6	51.2	51.9	54.4
HCL Tech QoQ growth, %	13.7%	-0.7%	6.6%	1.1%	1.4%	4.9%

Source: Companies, Emkay Research

No. of SAP consultants

Co Name	Pre acquisition	Post acquisition
Satyam	~4,300	~4,300
TCS	~3,800	~3,800
Infosys	~2,100	~2,100
HCL Tech	n.a	2000+

Further the inorganic move could diversify HCL Tech's exposure to more defensive sectors like public sector and utilities besides expanding presence in Europe. We note that HCL Tech has been witnessing trouble in its Financial services vertical (HBOS's takeover by Lloyds TSB could have aided to woes further, given that it happens to be a key account and recent dissent in the UK against outsourcing) along with a loss of client in BPO business and thus inorganic push might be needed to compensate for slowing organic growth.

Main challenges emanate from cultural integration, employee retention

Although the HCL Tech management underplayed the challenge citing its track record with acquisitions/take over of smaller captives from Deutsche Bank, British Telecom etc during the investor/analyst call we note that the smaller acquisitions put together added ~2,000 resources to HCL Tech over time while Axon could come with ~2,000 people at one go. Further we highlight that retention of key personnel could turn out to be a bigger challenge for HCL Tech as compared with Infosys given lower brand perception amongst the Indian IT vendors. We view the company management's description of the move as a 'merger' and not an 'acquisition' as a possible step to assuage employee confidence

Axon's growth could be tapering off, margins appear under pressure

We note that Axon's growth could taper off (consensus estimates build in revenue growth of only ~15% over CY07-CY09 V/s ~43% revenue CAGR over CY03-07) substantiated further by Axon's H1CY08 results (Axon's revenues from EMEA up by only ~12 % YoY V/s company wide growth rate of ~28%, for a complete snapshot of Axon's financials please refer table below). The Axon management had also acknowledged that growth could be slowing down in UK, its traditional foothold where it enjoys ~15%+ market share in the SAP implementation market

(in GBP mn except %)	CY05	CY06	CY07	1H08
Revenues	91.8	139.8	204.5	123.9
Gross Profits	22.9	40	56.3	31.9
Margins, %	24.9	28.6	27.5	25.7
Operating profits	7.6	18.1	30.6	16.5
Margins, %	8.3	12.9	15.0	13.3
Profit After Tax	6.3	12.4	20.2	10.8
Margins, %	6.9	8.9	9.9	8.7

Source: Company, Emkay Research

Axon acquisition could hit FY09 and FY10 earnings by ~2% and ~5%

On a first cut basis, we estimate that Axon acquisition could hit our earnings estimates for HCL Tech by ~2% and ~5% for FY09 and FY10 respectively. We have assumed that the acquisition gets consummated in Q1CY09, with debt costs at 7.5% p.a and GBP/USD at 1.85 for our calculations. Any counter bid by Infosys which raise the acquisition costs further could accentuate the negative impact further.

	FY08	FY09E	FY10E
HCL Tech Organic revenues(in US\$ mn)	1879	2278	2605
YoY growth, %		21.3%	14.4%
Axon Revenues(GBP)	204.5	241	269
(in US\$ mn)	378.3	445.9	497.7
To HCL Tech		148.6	497.7
Combined revenues(US\$ mn)	1879	2427	3103
YoY growth, %		29.2%	27.9%
Axon Group's PAT(GBP mn)	20.2	21.6	22.4
Axon Group's PAT contribution to HCL Tech(US\$ mn)		13.3	41.4
Interest on Debt (HCLT borrows's 400 mn GBP @LIBOR+400 bps)		18.5	55.5
Potential post tax other income loss on 76 mn\$@ 7%		1.8	5.3
Net Impact(in US\$ mn)		-6.9	-19.4
Net impact on Estimated Earnings		-2.0%	-5.1%

Source: Emkay Research

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