

Company Focus

17 July 2008 | 12 pages

HCL Infosystems (HCLI.BO)

Target price change ☒
Estimate change ☒

Buy: 6x FY09E EPS and 6.5% Dividend Yield

- **6x FY09E earnings and 6.5% dividend yield** — Current stock price, down 57% YTD, is already factoring in lower domestic demand and worst case for Nokia contract, in our view. We see HCL Info as a play on domestic tech spending and higher PC/telecom penetration – 20% earnings growth stock trading at 6x FY09E EPS and 6.5% dividend yield. We reiterate our Buy (1M) rating.
- **Channel check indicates higher prices of PCs** — Most of PC vendors have raised prices by 5-10% passing on higher prices from weaker INR and component price increases. Component prices have increased due to new Chinese labour laws and increase in raw material prices.
- **Higher interest rates and higher prices to affect demand** — We believe that consumer demand is likely to be affected by higher prices and higher interest rates. According to IDC, Indian PC market recorded 22% yoy growth in FY08 (Mar'08) with just 10% yoy growth in JFM'08 quarter.
- **Telecom business steady** — With telecom distribution behind, we expect revenue to track GSM subscriber net add and replacement demand starting this quarter (Jun'08). APJ is seasonally weak quarter and GSM subscribers net add declined by 5% qoq.
- **Reducing estimates and target price** — We have reduced our EPS by 7-8% to factor in lower domestic growth. Our new target price of Rs165 values hardware business at Rs107 (based on 8x EV/EBIT) and telecom business at Rs44 (NAV of Nokia contract with no terminal value) with net cash of Rs14.
- **Risks** — Lower domestic growth; market share losses and more INR weakness.

Buy/Medium Risk	1M
Price (17 Jul 08)	Rs123.50
Target price	Rs165.00
	from Rs266.00
Expected share price return	33.6%
Expected dividend yield	6.5%
Expected total return	40.1%
Market Cap	Rs21,138M
	US\$491M

Price Performance (RIC: HCLI.BO, BB: HCLI IN)



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
30 Jun	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2006A	2,805	16.45	21.9	7.5	3.0	44.8	6.5
2007A	3,158	18.56	12.8	6.7	2.4	40.6	6.5
2008E	3,151	18.52	-0.2	6.7	2.0	33.5	6.5
2009E	3,648	21.44	15.8	5.8	1.7	32.4	6.5
2010E	4,542	26.69	24.5	4.6	1.4	32.9	6.5

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.

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¹Citigroup Global Markets India Private Limited

Fiscal year end 30-Jun	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	7.5	6.7	6.7	5.8	4.6
EV/EBITDA adjusted (x)	4.7	4.4	4.1	3.4	2.7
P/BV (x)	3.0	2.4	2.0	1.7	1.4
Dividend yield (%)	6.5	6.5	6.5	6.5	6.5
Per Share Data (Rs)					
EPS adjusted	16.45	18.56	18.52	21.44	26.69
EPS reported	16.45	18.56	18.52	21.44	26.69
BVPS	41.35	50.82	60.35	72.82	90.58
DPS	8.00	8.00	8.00	8.00	8.00
Profit & Loss (RsM)					
Net sales	113,683	116,853	122,914	140,398	173,109
Operating expenses	-110,033	-112,967	-118,555	-135,258	-166,919
EBIT	3,650	3,886	4,358	5,140	6,190
Net interest expense	9	-105	-236	-286	-336
Non-operating/exceptionals	195	505	425	345	568
Pre-tax profit	3,854	4,286	4,548	5,199	6,421
Tax	-1,049	-1,128	-1,397	-1,552	-1,879
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	2,805	3,158	3,151	3,648	4,542
Adjusted earnings	2,805	3,158	3,151	3,648	4,542
Adjusted EBITDA	3,774	4,034	4,502	5,286	6,355
Growth Rates (%)					
Sales	46.8	2.8	5.2	14.2	23.3
EBIT adjusted	44.2	6.5	12.2	17.9	20.4
EBITDA adjusted	40.6	6.9	11.6	17.4	20.2
EPS adjusted	21.9	12.8	-0.2	15.8	24.5
Cash Flow (RsM)					
Operating cash flow	2,641	-105	1,970	2,879	2,877
Depreciation/amortization	124	148	144	146	166
Net working capital	-118	-3,028	-1,135	-855	-1,600
Investing cash flow	-144	-276	-60	-310	-361
Capital expenditure	-348	-676	-249	-370	-592
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	-1,341	-25	-1,039	-1,039	-1,039
Borrowings	33	1,513	500	500	500
Dividends paid	-1,535	-1,539	-1,539	-1,539	-1,539
Change in cash	1,157	-406	872	1,530	1,477
Balance Sheet (RsM)					
Total assets	19,359	25,833	28,557	33,352	40,944
Cash & cash equivalent	5,099	4,692	5,564	7,094	8,572
Accounts receivable	7,053	10,052	9,766	10,770	12,805
Net fixed assets	984	1,512	1,618	1,842	2,268
Total liabilities	12,382	17,237	18,348	21,034	25,623
Accounts payable	0	0	0	0	0
Total Debt	846	2,359	2,859	3,359	3,859
Shareholders' funds	6,977	8,597	10,209	12,318	15,322
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	3.3	3.5	3.7	3.8	3.7
ROE adjusted	44.8	40.6	33.5	32.4	32.9
ROIC adjusted	88.7	59.8	42.3	43.9	44.3
Net debt to equity	-61.0	-27.1	-26.5	-30.3	-30.8
Total debt to capital	10.8	21.5	21.9	21.4	20.1

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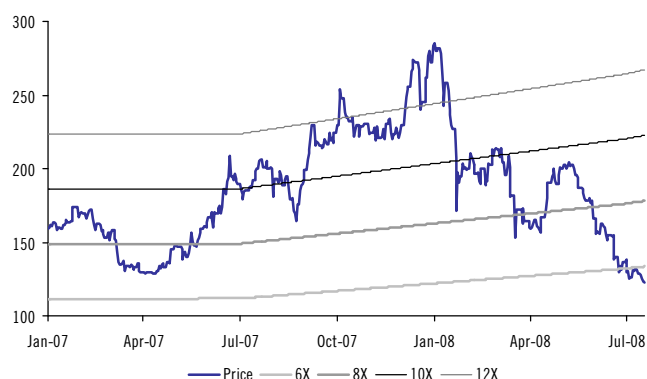


6x FY09E EPS and 6.5% Dividend Yield

HCL Infosystems stock has corrected c.57% YTD (underperformance of c.21% vs. BSE SENSEX) due primarily to: 1) broader market correction in India and regional hardware stocks; and 2) stronger INR over last few months.

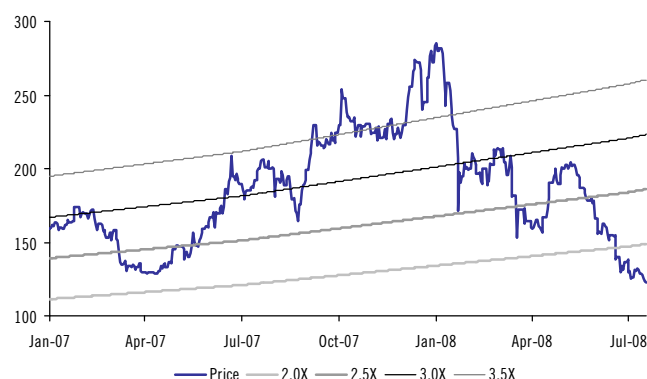
We believe that this correction is overdone and current stock price largely factors in all the negatives. At current prices, stock is trading at c.6x FY09E earnings and c.1.7x FY09E book value. The stock is trading close to its historical lows and we do not expect downside from current levels.

Figure 1. HCLI – 12-month Forward PER Band Chart



Source: DataStream, Company Reports and CIR Estimates

Figure 2. HCLI – 12-month Forward P/BV Band Chart



Source: DataStream, Company Reports and CIR Estimates

Figure 3. Earnings revision table

FYE	Net Profit (RsM)	EPS (Rs)	% chg	DPS (Rs)
30 Jun				
2008E	3,151	18.52	-0.6	8.00
Prev	3,170	18.63		8.00
2009E	3,648	21.44	-7.8	8.00
Prev	3,955	23.24		8.00
2010E	4,542	26.69	-7.8	8.00
Prev	4,929	28.96		8.00

Source: Citi Investment Research

Changes to our Model

We have reduced our estimates to factor in slower expected domestic tech spending in light of slower domestic growth forecast from our economist team. We have also marginally reduced our margin assumptions to factor recent weakness in INR. We have kept our telecom numbers largely unchanged and have incorporated new estimates for subscriber addition from our telecom team.

This leads to 7-8% reductions in our 2009/10 earnings estimates as shown in adjoining table.

Dividend yield provides valuation support

HCLI has a quarterly dividend policy with dividends of Rs2 per share. We expect it to maintain this dividend rate into the future in the absence of any major capex and comfortable free cash flows. With annual dividends of Rs8 per share, the stock trades at a dividend yield of 6.5%. This is an attractive dividend yield and should provide downside support, in our view.

SOTP-based target price of Rs165

Figure 4. SOTP Valuation

Hardware business	
FY09 EBIT	2,285
Target EV/EBIT	8.0x
EV	18,277
Value per share	107
Distribution business (NPV of Nokia contract)	
Value per share	44
Cash and Equivalents	
FY07 end net cash	2,333
Value per share	14
Fair Value	165
Target price	165

Source: Company Reports

We have revisited our target multiple for Hardware business, in light of higher risk-free interest rate, market correction and re-rating of regional hardware peers. We value HCLI using a sum-of-the-parts methodology: 1) Computer System (hardware) at an FY09E EV/EBIT of 8x (revised from 10x earlier); 2) Office Automation at a NPV of Nokia contract (with no terminal value of this business) – we are taking the most conservative view on this business and 3) cash per share of Rs14.

We have looked at regional hardware companies for comparable valuation and used their current trading multiple to value HCLI's hardware business. Asian PC-related peers trade at 8.5x CY08E and 7.4x CY09E - we have used 8x FY09E EV/EBIT (Jun-ending FY) for HCLI's hardware business. We believe 8x is fair for the hardware business against our estimate of a c.20% EBIT CAGR over FY07-10E.

Figure 5. Asian Hardware (PC related) — Valuation Comparison Table

Company	RIC	CIR	Mkt. cap	CMP	TP	P/E (x)		EV/EBIT (x)		EV/Sales(x)		P/BV (x)		Div. Yield (%)	
	Code	Rating	US\$m			LC	LC	CY08E	CY09E	CY08E	CY09E	CY08E	CY09E	CY08E	CY09E
PC/NB/MB															
Asustek	2357.TW	--	9,638	78.0	--	9.7	8.3	8.0	6.7	0.4	0.3	1.6	1.4	3.1%	3.8%
Lenovo Group*	0992.HK	1L	6,519	5.5	8.0	13.7	11.8	8.1	6.9	0.3	0.2	3.2	2.6	7.8%	7.8%
Quanta Computer	2382.TW	1M	5,190	45.4	65.0	33.2	27.1	5.6	4.7	0.1	0.1	6.2	5.7	2.0%	2.1%
Acer	2353.TW	--	4,743	58.2	--	11.1	9.5	10.5	8.5	0.2	0.2	1.8	1.7	6.3%	6.4%
Compal Electronics	2324.TW	1M	4,010	31.5	38.0	33.8	30.5	4.2	3.9	0.2	0.1	5.3	5.0	1.9%	2.1%
Wistron	3231.TW	3M	1,970	42.6	40.0	34.9	32.9	7.9	7.2	0.1	0.1	6.4	5.9	1.6%	1.6%
Micro-Star	2377.TW	--	578	18.5	--	8.3	7.2	9.6	7.9	0.2	0.2	0.7	0.7	4.3%	5.6%
Gigabyte	2376.TW	--	473	22.0	--	6.7	7.1	9.9	10.3	0.2	0.2	0.7	0.7	6.7%	6.8%
PC Components															
Hon Hai	2317.TW	--	30,040	145.0	--	11.5	9.8	9.0	7.6	0.4	0.4	2.1	1.8	2.1%	2.4%
FTC	2354.TW	--	3,574	143.0	--	13.1	10.7	11.7	9.8	0.8	0.7	2.0	1.8	2.8%	3.2%
Lite-on Tech	2301.TW	--	1,881	26.2	--	9.9	7.9	7.6	5.4	0.3	0.3	0.9	0.8	8.9%	9.7%
Cheng Uei Precision	2392.TW	--	787	59.5	--	10.5	10.8	10.4	10.3	0.5	0.4	1.3	1.2	3.9%	4.0%
Average						16.4	14.5	8.5	7.4	0.3	0.3	2.7	2.4	4.3%	4.6%

Pricing date: 17 July 2008

Source: Company Reports and Citi Investment Research estimates, IBES consensus estimates; LC = local currency; *using FY09 and FY10 for Mar-ending companies

Figure 6. Chinese Hardware Companies – Valuation Table

Company	RIC Code	Mkt. cap US\$m	CMP LC	P/E (x)			EPS CAGR 2007-09
				2007A/E	2008E	2009E	
Tsinghua Tongfang	600100.SS	2,220	20.12	29.7	22.8	15.3	39%
Haier	600690.SS	1,777	9.04	18.8	14.0	10.7	32%
TCL Group	000100.SZ	1,568	4.13	27.0	11.6	17.1	26%
Founder Tech	600601.SS	1,278	5.04	41.3	29.6	22.4	36%
China Greatwall	000066.SZ	365	4.52	-	14.3	10.7	-
Average				29.2	18.5	15.3	

Source: I/B/E/S estimates

HCL Infosystems

Company description

HCL Infosystems is a leading player in the PC (personal computer) and enterprise hardware space in India. It has market share of ~15-16% in the desktop market and ~6-7% in the notebooks market in India. Its range of offerings includes systems integration services to Indian corporates, with a strong presence in BFSI, telecom and e-governance verticals. The company also distributes technology and telecom products. It is the primary distributor of Nokia's GSM handsets in India.

Investment strategy

We rate HCLI Buy/Medium Risk with a target price of Rs165. HCLI is a play on the Indian government's and domestic industry's tech spending. With a focus on the system integration (SI) space, the company's hardware revenues should grow at a ~20% CAGR over FY07-10E on stable margins. The Nokia business has been a drag on HCLI's growth over the past few quarters. With re-distribution of the addressable market complete, we expect its Nokia handset business to recover after 4Q08 and grow at a ~14% CAGR over FY08-11E.

Valuation

We value HCLI at Rs165 using a sum-of-the-parts methodology: 1) Computer System (hardware) at Rs107 using an FY09E EV/EBIT of 8x; 2) Office Automation at Rs44 - a NPV of current Nokia contract without any terminal value, and 3) cash per share of Rs14. We believe 8x is fair for the hardware business against our estimate of a c.20% EBIT CAGR over FY07-10E. The multiple is in-line with the current peer-group average for HCLI's Asian peers. We value the office automation and telecom (primarily Nokia handset distribution) business conservatively at net present value of current Nokia contract (with no terminal value). We believe an SOTP-based target price is appropriate as the two business segments have different dynamics.

Risks

We rate HCLI Medium Risk based on our quantitative risk-rating system, which tracks 260-day historical share price volatility. Key downside risks to our target price include: 1) delays in system integration business execution; 2) market share losses in desktop and laptop market; 3) rupee depreciation leading to margin pressures; 4) slowdown in PC growth in domestic market; 5) tepid growth in non-Nokia business in office automation and distribution segment; 6) margin pressures leading to lower earnings growth; and 7) Nokia contract getting re-negotiated mid-way.

Lenovo Group

Valuation

Our 12-month target price for Lenovo of HK\$8 is based on 15x FY10E basic EPS. We believe 15x is reasonable as it is close to the mid-point of Lenovo's historical range of 9-26x, as well as consistent with our projected earnings growth rate for the company. We also use a two-stage DCF growth model, which yields a fair value of HK\$8. We assume medium-term growth of 12% and long-term growth of 5%, a terminal growth rate of 3.5%, a beta of 1.2 and a WACC of 14.5%. We prefer P/E as our primary valuation method for technology hardware companies, including Lenovo, as we believe earnings growth will be the main driver of their share prices.

Risks

We rate Lenovo Low Risk based on our quantitative risk-rating system, which tracks 260-day volatility. Risks to our target price include: 1) Competition for Lenovo in retaining IBM's customers, especially on the corporate side. Dell, HPQ and other competitors could start aggressively courting Lenovo/IBM's customers; 2) Margins could decline if component prices increase or the PC industry becomes more competitive; 3) Slowing global PC growth and a more competitive China PC market.

Quanta Computer

Valuation

We introduce our DCF-based target price of NT\$65, implying 12.1x FY08E EPS (or 12.5x FY08E EPS considering CB conversion of 111mn shares). At our target price, the stock would trade at an average of Quanta's employee adjusted 3-year forward P/E trading band of 6.9x-17.0x. We are using a DCF-based valuation to reflect Quanta's capability to generate stable cash inflows. Our DCF assumes revenue growth will maintain at 1.7% in 2018E as the growth in the global NB market might gradually saturate. We apply a cost of equity of 9.31%, which assumes a risk-free rate of 2.6%, a market risk premium of 6.0% and an equity beta of 1.12.

Risks

We have a Medium Risk rating on Quanta, based on our quantitative risk rating system, which tracks 260-day historical share price volatility. Downside risks that may cause the shares to trade below the current share price include: 1) sluggish end demand for notebook PCs in 2H08, 2) larger than expected gross margin decline due to rising component prices and irrational price cutting from competitors, and 3) unexpected FX losses caused by the volatility of the exchange rate of the US dollar and RMB. If any of these risks have a greater impact than we expect, the stock may not reach our target price.

Compal Electronics

Valuation

We introduce our DCF-based target price of NT\$38, implying 10.4x FY08E EPS (or 11.1x FY08E EPS considering CB conversion of 277mn shares). At our target price, the stock would trade at the average of Compal's employee adjusted 3-year forward P/E trading band of 7.3x-15.0x. We are using a DCF-based valuation to reflect Compal's capability to generate stable cash inflows. Our DCF assumes revenue growth will maintain at 1.7% in 2018E as the growth in the global NB market might gradually saturate. We apply a cost of equity of 9.35%, which assumes a risk-free rate of 2.6%, a market risk premium of 6.0% and an equity beta of 1.13.

Risks

We have a Medium Risk rating on Compal, based on our quantitative risk rating system, which tracks 260-day historical share price volatility. Downside risks that may cause the shares to trade below the current share price include: 1) sluggish end demand for notebook PC in 2H08, 2) larger than expected gross margin decline due to rising component prices and irrational price cutting from competitors, 3) weaker than expected performance from long-term investments such as Toppoly and VIBO, and 4) unexpected FX losses caused by the volatility of the exchange rate of the US dollar and RMB. If any of these risks has a greater impact than we expect, the stock may not reach our target price.

Wistron Corporation

Valuation

Our DCF-based target price is NT\$40, which implies 8.3x FY08E and 7.9x FY09E EPS. Considering Wistron's plan to issue 300m new shares, which could potentially dilute 18% of earnings, our target price would imply 10.1x FY08E and 9.6x FY09E EPS. At our target price, the stock would trade at the lower end of Wistron's employee adjusted 2-year forward P/E trading band of 8.9x-15.3x. Our DCF assumes revenue growth sustains at 1.7% in 2018E as growth in global NB market might gradually saturate. We apply a cost of equity of 9.46%, which assumes a risk-free rate of 2.6%, a market risk premium of 6.0%, and an equity beta of 1.14.

Risks

We have a Medium Risk rating on Wistron, based on our quantitative risk rating system which tracks 260-day historical share price volatility. Upside risks that may cause the shares to trade above our target price include: 1) Stronger than expected NB demand in 2H08, 2) the termination of LCD monitor acquisition plan, 3) smaller than expected gross margin decline by squeezing component makers or changing sales mix, and 4) strong execution ability to turn around LCD monitor business within a short period of time.

Appendix A-1

Analyst Certification

Each research analyst(s) principally responsible for the preparation and content of all or any identified portion of this research report hereby certifies that, with respect to each issuer or security or any identified portion of the report with respect to an issuer or security that the research analyst covers in this research report, all of the views expressed in this research report accurately reflect their personal views about those issuer(s) or securities. Each research analyst(s) also certify that no part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this research report.

IMPORTANT DISCLOSURES

Lenovo Group (0992.HK)

Ratings and Target Price History - Fundamental Research

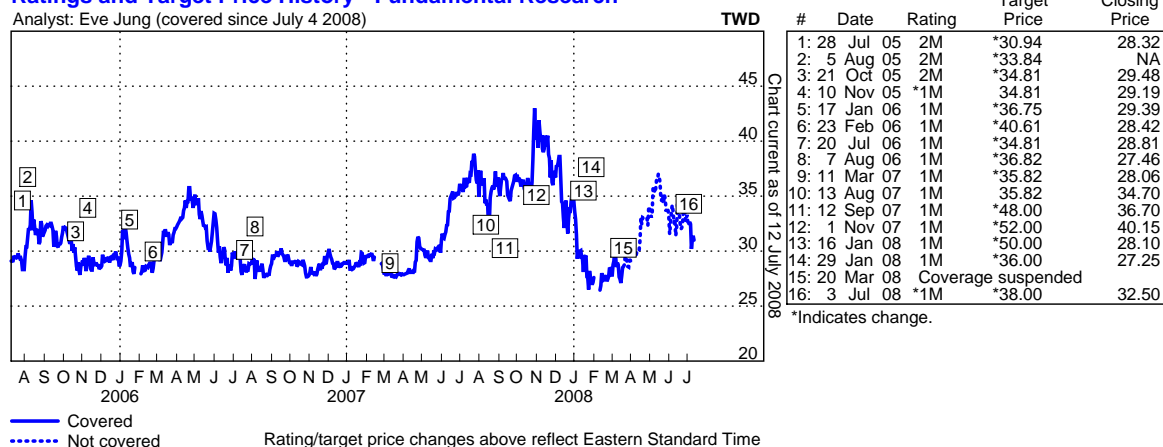
Analyst: Jim Liang, PhD (covered since February 19 2008)



Compal Electronics (2324.TW)

Ratings and Target Price History - Fundamental Research

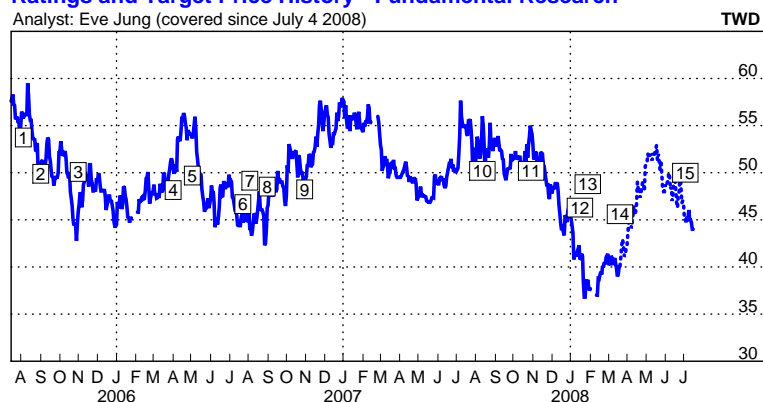
Analyst: Eve Jung (covered since July 4 2008)



17 July 2008

Quanta Computer (2382.TW)**Ratings and Target Price History - Fundamental Research**

Analyst: Eve Jung (covered since July 4 2008)



— Covered
 Not covered
 Rating/target price changes above reflect Eastern Standard Time

#	Date	Rating	Target Price	Closing Price
1:	4 Aug 05	1M	*65.36	55.75
2:	1 Sep 05	1M	*58.63	NA
3:	1 Nov 05	1M	*67.28	45.85
4:	3 Apr 06	1M	*62.48	50.47
5:	3 May 06	*2M	*57.67	53.64
6:	24 Jul 06	2M	*50.94	44.70
7:	3 Aug 06	2M	*50.98	43.92
8:	31 Aug 06	*1M	*52.94	46.27
9:	31 Oct 06	1M	*63.73	48.33
10:	13 Aug 07	1M	63.73	56.00
11:	30 Oct 07	1M	*68.00	54.50
12:	16 Jan 08	1M	*66.00	40.80
13:	29 Jan 08	1M	*49.00	38.65
14:	20 Mar 08	Coverage suspended		
15:	3 Jul 08	*1M	*65.00	45.00

*Indicates change.

Wistron Corporation (3231.TW)**Ratings and Target Price History - Fundamental Research**

Analyst: Eve Jung (covered since July 4 2008)



— Covered
 Not covered
 Rating/target price changes above reflect Eastern Standard Time

#	Date	Rating	Target Price	Closing Price
1:	30 Aug 05	3M	*30.55	27.66
2:	14 Oct 05	3M	*35.04	33.86
3:	26 Oct 05	*2M	*35.94	30.72
4:	9 Feb 06	2M	*43.13	37.81
5:	27 Mar 06	*1M	43.13	34.58
6:	4 May 06	1M	*49.42	38.13
7:	17 Aug 06	1M	*49.40	36.51
8:	29 Oct 06	1M	*45.28	35.81
9:	6 Mar 07	1M	*50.94	40.71
10:	29 Aug 07	1M	*68.00	58.50
11:	29 Oct 07	1M	*74.00	64.20
12:	16 Jan 08	1M	*70.00	44.65
13:	29 Jan 08	1M	*65.00	47.45
14:	20 Mar 08	Coverage suspended		
15:	3 Jul 08	*3M	*40.00	46.05

*Indicates change.

HCL Infosystems (HCLI.BO)**Ratings and Target Price History - Fundamental Research**

Analyst: Hitesh Shah, CFA (covered since December 4 2007)



— Covered
 Not covered
 Rating/target price changes above reflect Eastern Standard Time

#	Date	Rating	Target Price	Closing Price
1:	31 Aug 05	2M	270.00	262.55
2:	24 Jan 06	2M	*280.00	247.35
3:	19 Feb 06	*3M	*210.00	180.10
4:	25 Apr 06	3M	*180.00	169.70
5:	3 Dec 07	*1M	*305.00	230.00
6:	11 Apr 08	1M	*266.00	167.00

*Indicates change.

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