21 May 2010

Produced by: The Royal Bank of Scotland N.V., (India) Office

HCL Infosystems

Attack of the clones

Buy

Target price
Rs140.00 (from Rs168.00)

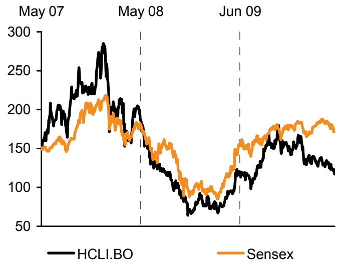
Price
Rs116.95

Short term (0-60 days)
n/a

Market view
Underweight

Price performance

	(1M)	(3M)	(12M)
Price (Rs)	131.8	134.8	117.3
Absolute (%)	-11.3	-13.2	-0.3
Rel market (%)	-5.7	-14.6	-16.7
Rel sector (%)	2.9	-10.7	-22.7



Market capitalisation
Rs26.06bn (US$556.65m)

Average (12M) daily turnover
Rs53.82m (US$1.16m)

RIC: HCLI.BO, HCLI IN
Priced Rs120.65 at close 20 May 2010.
Source: Bloomberg

We lower our handset volume forecasts 33/38% for FY11-12F as local players challenge Nokia's market share. As some product gaps are addressed, we expect volumes to stabilise at 3Q10 levels. Growth in the SI and PC businesses and c7% dividend yield should support earnings/valuations. Buy; lower TP of Rs140.

Key forecasts

	FY08A	FY09A	FY10F	FY11F	FY12F
Revenue (Rsm)	122,446	122,524	116,353	119,631	134,447
EBITDA (Rsm)	4,464	4,064	3,265 ▼	4,220 ▼	5,183 ▼
Reported net profit (Rsm)	3,002	2,400	2,277 ▼	2,912 ▼	3,597 ▼
Normalised net profit (Rsm)¹	3,002	2,400	2,277	2,912	3,597
Normalised EPS (Rs)	17.60	14.00	10.80 ▼	13.10 ▼	16.10 ▼
Dividend per share (Rs)	8.00	6.50	7.50	8.00	8.00
Dividend yield (%)	6.84	5.56	6.41	6.84	6.84
Normalised PE (x)	6.65	8.34	10.80	8.95	7.24
EV/EBITDA (x)	5.43	5.81	6.25	4.80	4.17
Price/book value (x)	1.97	1.78	1.35	1.26	1.18
ROIC (%)	46.70	31.20	24.00	20.00	22.90

Use of ▲ ▼ indicates that the line item has changed by at least 5%. 1. Post-goodwill amortisation and pre-exceptional items. Accounting standard: Indian GAAP
Source: Company data, RBS forecasts

year to Jun, fully diluted

Nokia's dominance is challenged by rise of local players and greater MNC competition

Local players have recently captured significant share of the handset market (17.5% in Dec-09 quarter, according to IDC), replacing grey market handsets and benefiting for the multi-SIM phenomenon. Outsourced design/manufacturing has helped these players churn out products (one month from design to market, cites one player) and some have distribution scales rivalling Tier-2 MNC vendors. We also note the narrowing gap in terms of product breadth between Nokia and MNC peers, and Samsung in particular. Consequently, we expect Nokia's market share to remain challenged . However, refreshing the portfolio to address certain gaps could help stabilise volumes following an estimated 20%+ qoq drop in 3QFY10. We reduce our HCLI handset volume forecasts by 33% for FY11F and by 38% for FY12F.

PC/SI top-line cues remain positive, although margin implications remain neutral

HCLI's 3QFY10 system integration (SI) revenues rebounded to Rs2.4bn, matching 1HFY10 cumulative revenues. Execution in the next two quarters is highly visible with Commonwealth Games-related orders of Rs5bn. We expect core PC revenue growth to continue (c10%+ yoy in 3QFY10) as the PC cycle revives and we raise our overall PC business forecasts by 3%/8% for FY11/12F. We expect consolidated SG&A costs to remain high in the medium term (-157/-191bp impact for FY11/12F) as PC branding costs and the scale-up of the services business neutralise the mix benefit from lower handset forecasts. A sharp Rs/US$ depreciation (5% qtd) also limits the benefit of less aggressive discounting in consumer PCs.

Steadier operating performance and dividend yield should support valuations

The stock has fallen 10% in the past three months versus a 2% rise in the Sensex, given the weak 3QFY10 results. We expect a steadier performance going forward to drive valuations over the next 12 months, although near-term sentiment could remain weak due to handset business competition and rupee depreciation. The dividend yield of around 7% restricts the significant downside from the current levels, in our view. We reiterate our Buy rating.

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Important disclosures can be found in the Disclosures Appendix.

Attack of the clones

We lower our handset volume forecasts by 33% for FY11F and 38% for FY12F given the rise of local players and MNC peers lowering product breadth gap to Nokia. However, we expect positive cues in PC/SI to help steady HCLI's operating performance going forward.

Rise of local labels has disrupted the handset market significantly

The Indian mobile handset market has recently seen a slew of product launches from both local players and lesser known foreign companies. A recent survey by IDC also highlights the growing presence of new vendors – from a 0.9% share of shipments in January-March 2008 to 17.5% in October-December 2009 – while the number of local vendors has grown from five to 28 during that period.

Table 1 : Background of local entrants

Company	No. of handsets	Background
Maxx	45	Manufacturer of handset chargers and batteries
Bleu	32	Brand of European handset maker Sagem
Karbonn	29	JV of UTL (telecom equipment/services supplier) and Jaina group (distributor)
Micromax	28	Entrepreneurial management with background in PC distribution
Rage	26	Sunstrike Telecom
GeePee	26	Promoters have interests in textiles and FMCG businesses
Onida	25	Domestic consumer electronics company
Videocon	24	Domestic consumer electronics company - also rolling out 2G operations currently
Usha-Lexus	23	Domestic home appliances company
Spice	22	Modi group - sold its telecom service operations to Idea
Intex	21	Manufacturer of computer peripherals and parts
Byond Tech	18	Canpex group (chemical manufacturer and trader)
Fly	17	European handset brand
Airfone	16	Based in Kolkata – no more details available
Zen	14	Distributor of mobile handsets in India for the last 15 years
Lava	9	Entrepreneurial management with background in handset servicing
Sky	9	Based in Kolkata – no more details available
Olive	8	JV with Haier group - Chinese handset manufacturer
Movil	6	Promoter headed Fly mobile's India operations earlier
Ray	4	Home label of Mobile Store - a handset retail chain of the Essar group
INQ	3	European handset brand
Ajanta	3	Manufacturer of clocks and electronic appliances

Source: Company data, media reports

We believe some of the new players have benefited from the vacuum created by the ban on imported handsets without an IMEI (International Mobile Equipment Identity) number that came into effect in June 2008. This ban was followed by a notification that any such handsets would be disconnected from mobile operators' networks from the end of November 2009, leading to a forced replacement cycle for such handsets. Our channel checks indicate that this segment of the market largely migrated to domestic labelled handsets, rather than MNC brands.

There has been a marked increase in reported monthly subscriber additions in the past 12 months – up to 20.2m in March 2010 from 15.6m in March 2009. Industry sources estimate that about 30-50% of these additions are attributable to multi-SIM usage, which in turn resulted from the pricing differential between various plans and the low cost of entry. In addition, the differential on/off net pricing gave the consumer scope for cost arbitrage, resulting in a need for phones that could hold two active SIM cards. A further driver of dual-SIM handsets has been the move by CDMA operators in India towards open-market handsets (the first handset of this kind was launched in August 2009).

Our analysis of handset models currently offered by these new entrants suggests that nearly 80% of the handsets offered by the five leading local players come with multiple SIM card slots. Entrenched mobile operators were late into this segment, which was initially regarded as a small niche but now constitutes around 12% of industry sales, according to industry sources. We note that Samsung has launched dual-SIM handsets, while Nokia has not yet announced any plans to launch one.

This time, competition looks set to stay

We view the onset of domestic competition as a more serious threat to entrenched players than the earlier wave of unbranded imported handsets. Indeed, several of the new players have indicated they intend to compete on a long-term basis – as evidenced, for example, by the 'high–decibel' advertising (particularly during the recently concluded T20 World Cup and IPL cricketing events), the endorsement of sports and movie celebrities as well as their investments in distribution.

These players have also been offering products typically with a one-year warranty and offer after-sales support, which help provide comfort to prospective customers. We note that many of the new local players are piggybacking on their existing distribution infrastructures (Intex – computer parts, Karbonn – Jaina group, and Ray – themobilestore.com) or have a background in consumer durables (Videcon, Onida and Usha-Lexus). Some of these players have scaled up their presence in retail outlets, matching the scale of Tier-2 MNC vendors such as Samsung and Sony. Dealer commissions are also more attractive than MNC peers. Our channel checks suggest that retailers typically get a 4-5% mark-up on local brand sales vs 2-3% for MNC players, thereby incentivising them to push their brands to the customer.

Table 2 : Distribution reach of local players

	Outlets reached
MicroMax	70,000
Karbonn	50,000
Spice	50,000
Videocon	40,000
Lava	16,000
Intex	12,000
Fly	6,000
Movil	4,000

Source: Company data, media reports

Rapid product rollout of local players is supported by an ecosystem of ODM suppliers

Some of the early successes of the local players can be traced to their offering product features that addressed unmet needs of customers, such as: 1) multi-SIM usage; 2) long battery life/back-up battery and 3) an FM/AM radio. We note that new products are moving up in terms of features/design. Several Qwerty keypad and touch-screen phones are now available. Recent examples of innovation include a model from Micromax that offers a gaming experience similar to a Nintendo WII console and a 12mp camera phone from Spice Mobiles.

The rapid proliferation of such players is supported by an ecosystem of suppliers based out of Asia. Typically, each company has an in-house design team that works on basic product features and aesthetics, while the product is designed and manufactured in other Asian countries. We note that Mediatek, a supplier of chipsets for GSM phones shipped by the local players, estimates its market share in India at 30% in 2009, and targets increasing this to 50% in the current year. One local label indicated that the lead time from furnishing basic aesthetic and functional requirements to manufacturing of phones is now just one month.

MNC competition has also been more aggressive of late

Nokia's incumbency advantage has historically been due to its wide breadth of products and distribution reach. We believe its distribution reach remains an advantage relative to other MNC peers. However, in terms of its product portfolio, its peers (particularly Samsung) have been catching up. We also note that some players such as HTC and RiM have made inroads into niche higher-end products.

We reduce handset revenue forecasts by 30-35% for FY11-13F

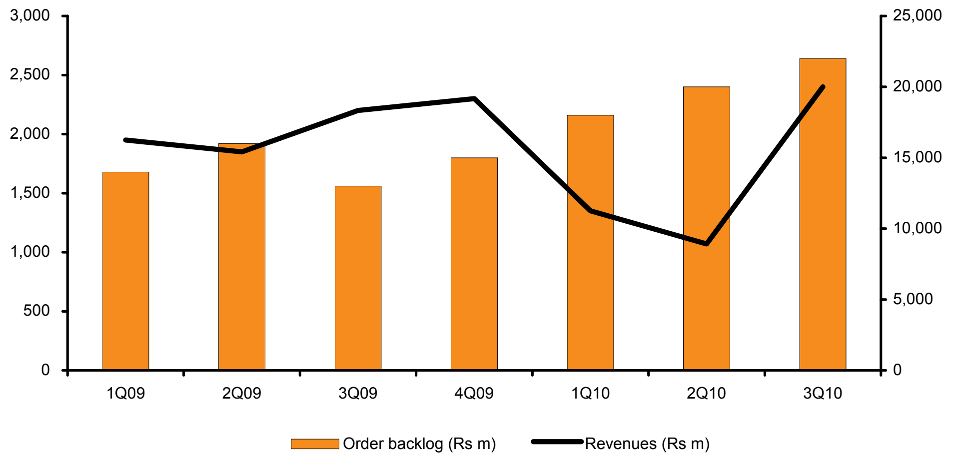
The rise of the local players has clearly been far stronger than our expectations. We expect HCLI's volumes to be range-bound in the near term, at last quarter's levels, as its launch of new products should provide support. However, we expect its market share to continue to be challenged over the next two to three years, given the emergence of a new breed of lower-end competitors. Our new forecasts build in a 12% decline in volumes in FY11F, followed by a modest 5% annual increase in volumes in FY12-13F. We also expect a structural decline in ASPs (2.5% yoy over FY11-13F).

SI/PC business back on track, but margins have trailed expectations

HCLI reported system integration (SI) revenues of Rs2.4bn in 3QFY10, the same level as in the whole of a disappointing 1HFY10. Order booking momentum remains positive (Rs500m in 3QFY10) and implementation of an estimated Rs5bn of projects related to the Commonwealth Games (due to kick off in October 2010) should keep revenue booking buoyant in the near term.

Although we expect competition to intensify with a focus on large Indian/MNC peers on the domestic market, we believe HCLI has several opportunities in the domestic space where it has won bids in the past – APDRP contracts, alternative communications network for the Armed Forces and continued spending on various e-governance programmes. Management also sees a healthy funnel of deals from its security practice. We project an order intake of Rs22bn/25bn in FY11/12F versus Rs13.5bn over 9MFY10.

Chart 1 : System integration revenues and order backlog trends

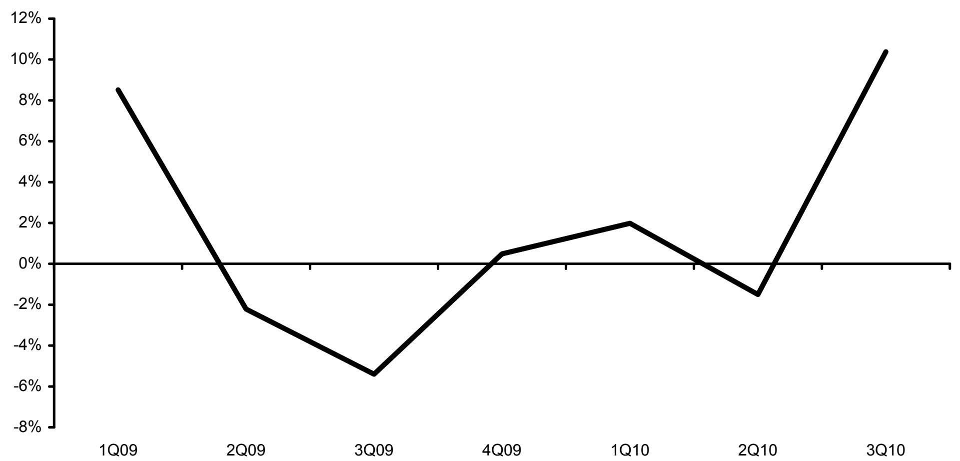


Source: Company data

While we project SI revenues to drop c10% in FY10 due to weak execution in 1H10, we expect strong 91%/44% growth in FY11/12F, which we believe is achievable based on the current order book (FY11F revenues at 65% of current order book) and high visibility on new contract wins.

HCLI's core PC business revenues (ex-SI) grew c17% qoq, which was surprisingly strong given management's earlier indications that seasonal strength would not be as notable this year as it has been in the past. We believe some of the outperformance could have come from lower discounting and better mix from its new product line-up. Management also highlighted strong growth in the services business as a driver for the outperformance. We project a 19%/16% growth in core PC revenues over FY11/12F. For the overall PC business (including SI), we project 35%/25% growth over FY11/12F.

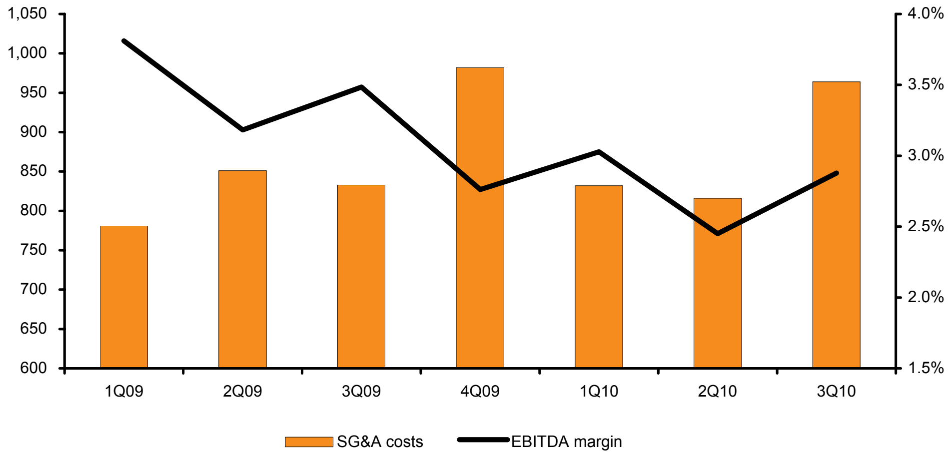
Chart 2 : Core PC revenue growth (yoy)



Source: Company data

Consolidated SG&A costs in 3Q10 were up 18% qoq, impacting margins by c73bp. Management indicated the reasons for the increase were scaling up of SI and services practices, A&P spends to promote new PC ranges as well as consulting costs associated with M&A prospecting. We expect these higher spend levels to be largely recurring in the medium term, and hence build these into our medium-term forecasts. Higher operating cost assumptions impact our margin forecasts for FY11/12F by 157bp/191bp, thereby neutralising the benefit of overall mix change (lower handset sales forecasts). We also expect the recent sharp depreciation in the rupee versus US dollar (5% qtd) to restrict upside from incrementally less aggressive competition in the consumer segment. Consequently our consolidated EBITDA margin forecasts are largely unchanged.

Chart 3 : Trend in SG&A costs and EBITDA margins



Note: 2Q09 and 4Q09 include higher receivables provisioning of Rs90m and cRs130m respectively
Source: Company data

3Q10 results review

Table 3 : Key financials

(Rs m)	1Q09	2Q09	3Q09	4Q09	FY09	1Q10	2Q10	3Q10
	2.5%	2.7%	2.8%	3.2%	2.8%	2.8%	2.7%	3.4%
Gross sales	31,258	31,401	30,238	31,329	124,226	30,275	30,543	28,425
Excise duty	397	322	276	266	1,261	285	228	280
Net sales	**30,861**	**31,079**	**29,962**	**31,063**	**122,965**	**29,990**	**30,315**	**28,145**
Change (yoy)	***-0.2%***	***-5.0%***	***0.4%***	***-0.3%***	***-1.3%***	***-2.8%***	***-2.5%***	***-6.1%***
(increase)/decrease in stock in trade	-932	327	-1,279	1,698	-186	1,106	-549	995
Cost of sales	29,026	28,047	28,482	26,699	112,254	26,248	28,359	24,402
Gross profit	**2,767**	**2,705**	**2,759**	**2,666**	**10,897**	**2,636**	**2,505**	**2,748**
Gross margin	***9.0%***	***8.7%***	***9.2%***	***8.6%***	***8.9%***	***8.8%***	***8.3%***	***9.8%***
Staff cost	810	865	882	826	3,383	896	946	974
Admin, selling, repairs & others	781	851	833	982	3,447	832	816	964
EBITDA	**1,176**	**989**	**1,044**	**858**	**4,067**	**908**	**743**	**810**
EBITDA margin	***3.81%***	***3.18%***	***3.48%***	***2.76%***	***3.3%***	***3.03%***	***2.45%***	***2.88%***
Depreciation	47	51	56	59	213	59	69	56
EBIT	**1,129**	**938**	**988**	**799**	**3,854**	**849**	**674**	**754**
EBIT margin	***3.7%***	***3.0%***	***3.3%***	***2.6%***	***3.1%***	***2.8%***	***2.2%***	***2.7%***
Total non-operating income	**-169**	**-127**	**-93**	**49**	**-340**	**-20**	**105**	**140**
Forex gains/(losses)	-165	-96	-71	68	-264	-17	65	123
Other income ex forex gains	73	76	100	82	331	81	137	108
Interest and finance expenses	77	107	122	101	407	84	97	91
Profit before taxes	**960**	**811**	**895**	**848**	**3,514**	**829**	**779**	**894**
Tax expense	299	257	314	244	1,114	240	219	293
Profit after tax	**661**	**554**	**581**	**604**	**2,400**	**589**	**560**	**601**
Change (yoy)	***-8%***	***-32%***	***-29%***	***-7%***	***-20%***	***-11%***	***1%***	***3%***
Adj. basic EPS	**3.86**	**3.24**	**3.39**	**3.53**	**14.02**	**3.44**	**2.70**	**2.75**
Change (yoy)	***-9.1%***	***-32.3%***	***-28.8%***	***-7.3%***	***-20.2%***	***-10.9%***	***-16.7%***	***-18.9%***

Comments

- QOQ 19% decline in reselling revenues, largely to lower handset volumes
- SI revenues up 124% qoq to Rs2.4bn (up 9% yoy); core PC revenues (ex-SI) up 17% qoq (up 10% yoy) due to seasonal strength in government verticals
- 18% qoq increase in SG&A costs attributed to branding expenses and scaling up IT services business
- Consolidated EBITDA margins improved over 2Q10 trough levels, but tracked below normalised levels of 3.3% in FY10
- Management guided to regular capex of cRs700m on an annualised basis and some top-up project-related capex
- Tax rate at 32.8% (28.1% in 2Q10) due to higher contribution from SI business (fully taxable) and lower product mix from tax-exempt unit
- EPS decline of 19% versus PAT increase of 3% due to residual dilution of placement of fresh shares and warrants in 2Q10
- Quarterly dividend maintained at Rs2/share

Source: Company data

Table 4 : Segmental performance

(Rs m)	3Q09	2Q10	3Q10	qoq	yoy	9M09	9M10	Change
Net sales								
Consolidated	29,962	30,315	28,145	-7.2%	-6.1%	91,901	88,450	-3.8%
- Computer hardware and services	8,473	6,990	9,324	33.4%	10.0%	24,695	24,203	-2.0%
- Telecom and office automation	21,582	23,288	18,847	-19.1%	-12.7%	67,406	64,351	-4.5%
EBIT								
Consolidated	1,035	862	1,030	19.5%	-0.5%	3,076	2,876	-6.5%
- Computer hardware and services	408	280	529	88.9%	29.7%	1,250	1,292	3.3%
- Telecom and office automation	682	570	535	-6.1%	-21.6%	1,919	1,661	-13.5%
EBIT margin								
Consolidated	3.5%	2.8%	3.7%	82bp	21bp	2.1%	1.9%	-21bp
- Computer hardware and services	4.8%	4.0%	5.7%	167bp	86bp	5.1%	5.3%	27bp
- Telecom and office automation	3.2%	2.45%	2.84%	39bp	-32bp	4.56%	4.47%	-9bp

Comments

- Management attributed some portion of the revenue drop to handset inventory tightness ahead of product refresh, in addition to competition
- Pick-up in PC revenues attributed to broad-based traction in the enterprise segment and services revenue growth
- Internet services revenues down 29% qoq to Rs177m, while PBIT was negative to Rs34m (+Rs12m in 2Q10)

Source: Company data

Worst seems priced in; reiterate Buy

We cut our FY11/12F EPS 21%/18% and our target price to Rs140 (from Rs168) due to lower handset volume forecasts. With Nokia refreshing its product and positive momentum in the PC/SI business, we see a more stable operating environment. Reiterate Buy.

We reduce our revenue forecasts by c20% for FY11/12F, primarily include 30%/33% lower reselling revenues on severe market pressures in the handset business, while raising PC revenue forecasts 3%/8% on better-than-expected performance in the core PC business and SI order inflow. We only marginally revise our EBITDA margin forecasts, as we expect structurally higher SG&A costs in the medium term (due to investments in services/SI business) to be offset by better revenue mix (lower handset revenues). Consequently, our EPS forecasts are down 21%/18% for FY11/12F.

Table 5 : What has changed in our key forecasts and assumptions

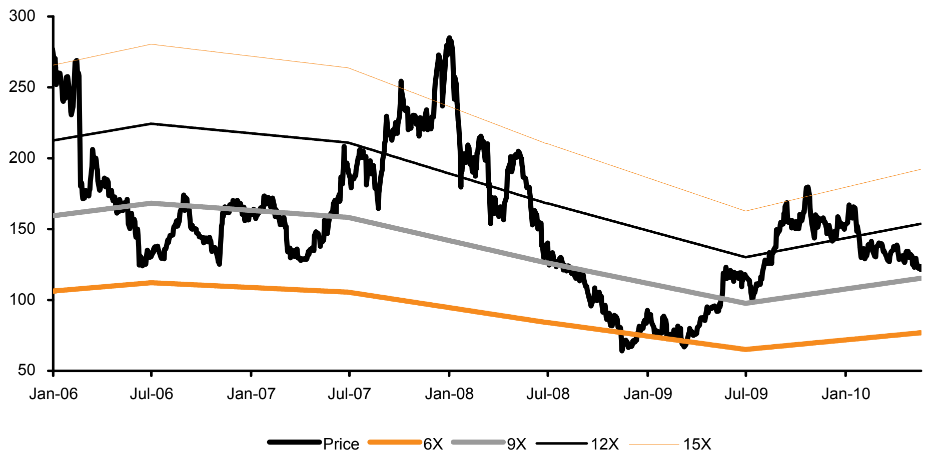
	FY10F	FY11F	FY12F		FY10F	FY11F	FY12F	Comments
Telecom and office automation business								▪ We cut handset volume forecasts
Revenue (Rs m)				**EBITDA margin**				33%/38% for FY11/12, while broadly
- old	95,044	105,640	116,124	- old	2.5%	2.7%	2.9%	maintaining ASP forecasts
- new	82,510	73,948	77,513	- new	2.4%	2.6%	2.8%	▪ We raise FY12 SI revenue forecasts
change	*-13.2%*	*-30.0%*	*-33.2%*	*change*	*-15bp*	*-17bp*	*-11bp*	c11%, given robust order book position
Computer hardware and services business								and healthy deal pipeline
Revenue (Rs m)		**35.0%**	**24.6%**	**EBITDA margin**				▪ Our core manufacturing forecasts are up
- old	33,021	44,378	52,493	- old	4.3%	5.5%	5.8%	6%/9% in FY11/FY12, building in
- new	33,844	45,683	56,934	- new	3.9%	5.1%	5.3%	significant outperformance in 4Q10 as
change	*2.5%*	*2.9%*	*8.5%*	*change*	*-43bp*	*-38bp*	*-41bp*	well as marginally higher share in
Consolidated								notebooks, given the company's
Revenue (Rs m)				**EBITDA margin**				investments in branding
- old	128,065	150,018	168,616	- old	3.0%	3.5%	3.8%	▪ Our EBITDA margin forecasts factor in
- new	116,353	119,631	134,447	- new	2.8%	3.5%	3.9%	the benefit of mix change and higher
change	*-9.1%*	*-20.3%*	*-20.3%*	*change*	*-17bp*	*-2bp*	*9bp*	SG&A costs (157bp/191bp for FY11/12)
Tax provision (as % of PBT)				**EPS - basic**				▪ Capex forecasts raised to Rs1.1bn for
- old	30.1%	31.0%	30.8%	- old	12.6	16.8	19.7	FY11/12 (Rs1bn/Rs0.8bn previously) to
- new	30.3%	30.8%	30.2%	- new	11.0	13.2	16.1	factor in additional investments in
change	*24bp*	*-18bp*	*-52bp*	*change*	*-12.2%*	*-21.5%*	*-17.8%*	service delivery facilities

Source: Company data, RBS forecasts

We reiterate our Buy rating with a DCF-based target price of Rs140 (from Rs168)

We arrive at a DCF-based target price at Rs140 (Rs168 previously) using a WACC of 13.9%, which implies a valuation of 10.7x FY11F EPS and offers potential upside of 20% to the CMP in addition to a dividend yield of c7%. We believe that negatives are largely priced into the stock, and stability in the handset business and tailwinds in the SI/PC business should support near-term earnings.

Chart 4 : HCL Infosystems: 12-month forward P/E band chart



Source: Bloomberg, Company data, RBS forecasts

Risks to our target price

Key downside risks to our rating and target price are: 1) a change in the company's contracts with various reselling partners, including Nokia, 2) increased competition in its markets that could affect market share beyond our estimates, 3) a faster-than-expected slowdown in mobile subscriber growth that could negatively impact handset sales, 4) a slowdown in the Indian economy (could affect both enterprise and retail demand), and 5) rupee depreciation (would affect the import costs of key hardware components).

Key forecasts and assumptions

Table 6 : Key forecasts and assumptions

(Rs m)	FY08A	FY09A	FY10F	FY11F	FY12F
Computer hardware and services business					
Revenue (Rs m)	32,311	34,139	33,844	45,683	56,934
- Hardware sales (net of excise)	28,577	28,912	27,183	35,901	43,214
- Services	3,734	5,227	6,661	9,782	13,720
PC shipment (m)	8.4	7.3	8.6	10.4	12.3
PC shipment distribution					
- Desktop PCs	73%	71%	64%	59%	57%
- Notebook PCs	27%	29%	36%	41%	43%
HCLI market share - Desktop	11.9%	11.1%	10.3%	9.9%	9.6%
ASP - Desktop (Rs)	19,149	20,467	19,503	18,683	17,750
HCLI market share - Notebooks	7.3%	6.7%	5.4%	6.5%	7.0%
ASP - Notebooks (Rs)	29,083	30,821	28,994	27,251	25,340
EBITDA (Rs m)	1,808	1,792	1,314	2,321	3,044
EBITDA margin (%)	*5.6%*	*5.2%*	*3.9%*	*5.1%*	*5.3%*
Telecom and office automation business					
Revenue (Rs m)	92,162	88,826	82,510	73,948	77,513
HCLI handsets volumes	31	31	28	25	26
ASP (Rs)	2,674	2,530	2,597	2,533	2,470
EBITDA (Rs m)	2,605	2,275	1,951	1,898	2,138
EBITDA margin (%)	*2.8%*	*2.6%*	*2.4%*	*2.6%*	*2.8%*
Consolidated					
Revenue (Rs m)	124,473	122,965	116,353	119,631	134,447
EBITDA (Rs m)	4,413	4,067	3,265	4,220	5,183
EBITDA margin (%)	*3.5%*	*3.3%*	*2.8%*	*3.5%*	*3.9%*
PAT	**3,000**	**2,400**	**2,277**	**2,912**	**3,597**
Growth	***-4.9%***	***-20.0%***	***-5.1%***	***27.9%***	***23.5%***
Adj. basic EPS (Rs)	**17.6**	**14.0**	**11.0**	**13.2**	**16.1**
Shares outstanding - basic (m)	171	171	218	223	223

Source: Company data, RBS forecasts

Income statement

Rsm	FY08A	FY09A	FY10F	FY11F	FY12F
Revenue	122446	122524	116353	119631	134447
Cost of sales	-111908	-111630	-105681	-106446	-118542
Operating costs	-6074	-6830	-7408	-8965	-10723
EBITDA	**4464**	**4064**	**3265**	**4220**	**5183**
DDA & Impairment (ex gw)	-186.2	-212.5	-255.7	-310.5	-348.0
EBITA	**4278**	**3852**	**3009**	**3909**	**4835**
Goodwill (amort/impaired)	n/a	n/a	n/a	n/a	n/a
EBIT	**4278**	**3852**	**3009**	**3909**	**4835**
Net interest	0.00	0.00	0.00	0.00	0.00
Associates (pre-tax)	n/a	n/a	n/a	n/a	n/a
Forex gain / (loss)	n/a	n/a	n/a	n/a	n/a
Exceptionals (pre-tax)	0.00	0.00	0.00	0.00	0.00
Other pre-tax items	23.4	-338.8	260.2	298.0	322.0
Reported PTP	**4301**	**3513**	**3269**	**4207**	**5157**
Taxation	-1300	-1114	-992.2	-1295	-1559
Minority interests	n/a	n/a	n/a	n/a	n/a
Exceptionals (post-tax)	n/a	n/a	n/a	n/a	n/a
Other post-tax items	0.00	0.00	0.00	0.00	0.00
Reported net profit	**3002**	**2400**	**2277**	**2912**	**3597**
Normalised Items Excl. GW	0.00	0.00	0.00	0.00	0.00
Normalised net profit	**3002**	**2400**	**2277**	**2912**	**3597**

Source: Company data, RBS forecasts year to Jun

Balance sheet

Rsm	FY08A	FY09A	FY10F	FY11F	FY12F
Cash & market secs (1)	5348	4701	10475	10155	8286
Other current assets	23853	27016	28102	30205	35419
Tangible fixed assets	1698	1852	2959	3731	4450
Intang assets (incl gw)	n/a	n/a	n/a	n/a	n/a
Oth non-curr assets	0.00	0.00	0.00	0.00	0.00
Total assets	**30899**	**33569**	**41535**	**44091**	**48155**
Short term debt (2)	n/a	n/a	n/a	n/a	n/a
Trade & oth current liab	17125	20138	17529	19219	22271
Long term debt (3)	3545	2268	4834	4334	3834
Oth non-current liab	67.0	n/m	n/m	n/m	n/m
Total liabilities	**20737**	**22350**	**22245**	**23435**	**25987**
Total equity (incl min)	10162	11219	19291	20656	22168
Total liab & sh equity	**30899**	**33569**	**41535**	**44091**	**48155**
Net debt	-1803	-2433	-5641	-5821	-4452

Source: Company data, RBS forecasts year ended Jun

Cash flow statement

Rsm	FY08A	FY09A	FY10F	FY11F	FY12F
EBITDA	4464	4064	3265	4220	5183
Change in working capital	-1852	-150.0	-3695	-412.6	-2162
Net interest (pd) / rec	23.4	-338.8	260.2	298.0	322.0
Taxes paid	-1358	-1237	-1054	-1295	-1559
Other oper cash items	n/a	n/a	n/a	n/a	n/a
Cash flow from ops (1)	**1278**	**2339**	**-1224**	**2810**	**1784**
Capex (2)	-372.0	-366.5	-1362	-1083	-1067
Disposals/(acquisitions)	0.00	0.00	0.00	0.00	0.00
Other investing cash flow	0.00	0.00	0.00	0.00	0.00
Cash flow from invest (3)	**-372.0**	**-366.5**	**-1362**	**-1083**	**-1067**
Incr / (decr) in equity	165.6	-40.5	7655	480.4	-58.7
Incr / (decr) in debt	1186	-1277	2566	-500.0	-500.0
Ordinary dividend paid	-1602	-1302	-1861	-2027	-2027
Preferred dividends (4)	n/a	n/a	n/a	n/a	n/a
Other financing cash flow	0.00	0.00	0.00	0.00	0.00
Cash flow from fin (5)	**-250.2**	**-2620**	**8360**	**-2046**	**-2586**
Forex & disc ops (6)	n/a	n/a	n/a	n/a	n/a
Inc/(decr) cash (1+3+5+6)	**655.6**	**-647.0**	**5774**	**-319.6**	**-1869**
Equity FCF (1+2+4)	905.8	1973	-2587	1727	716.9

Lines in bold can be derived from the immediately preceding lines. year to Jun
Source: Company data, RBS forecasts

Standard ratios

	HCL Infosystems					Acer Inc			MediaTek Inc		
Performance	**FY08A**	**FY09A**	**FY10F**	**FY11F**	**FY12F**	**FY10F**	**FY11F**	**FY12F**	**FY10F**	**FY11F**	**FY12F**
Sales growth (%)	4.79	0.06	-5.04	2.82	12.4	27.9	12.9	8.68	17.0	11.0	5.11
EBITDA growth (%)	10.6	-8.95	-19.7	29.2	22.8	28.0	18.0	11.9	18.2	12.3	6.28
EBIT growth (%)	10.0	-9.96	-21.9	29.9	23.7	44.4	19.0	12.4	23.6	12.3	6.31
Normalised EPS growth (%)	-5.97	-20.3	-22.6	20.5	23.5	47.9	19.9	12.9	20.1	8.91	-0.59
EBITDA margin (%)	3.65	3.32	2.81	3.53	3.85	3.15	3.29	3.39	34.4	34.8	35.1
EBIT margin (%)	3.49	3.14	2.59	3.27	3.60	3.02	3.18	3.29	33.4	33.8	34.1
Net profit margin (%)	2.45	1.96	1.96	2.43	2.68	2.29	2.43	2.53	32.5	31.9	30.2
Return on avg assets (%)	10.6	7.44	6.06	6.80	7.80	6.15	7.07	7.35	31.0	33.0	33.2
Return on avg equity (%)	32.0	22.4	14.9	14.6	16.8	17.1	18.4	18.4	39.2	41.6	42.4
ROIC (%)	46.7	31.2	24.0	20.0	22.9	39.8	26.6	26.9	290.3	223.0	205.4
ROIC - WACC (%)	32.8	17.3	10.1	6.09	9.02	32.3	19.1	19.4	280.2	212.9	195.3
					year to Jun			year to Dec			year to Dec
Valuation											
EV/sales (x)	0.20	0.19	0.18	0.17	0.16	0.26	0.23	0.20	3.24	2.94	2.84
EV/EBITDA (x)	5.43	5.81	6.25	4.80	4.17	8.26	6.95	5.99	9.42	8.45	8.08
EV/EBITDA @ tgt price (x)	6.58	7.08	7.83	6.01	5.16	10.5	8.87	7.71	11.2	10.1	9.59
EV/EBIT (x)	5.67	6.13	6.79	5.18	4.47	8.61	7.19	6.16	9.70	8.70	8.31
EV/invested capital (x)	2.88	2.71	1.51	1.38	1.23	1.93	1.72	1.54	25.7	22.4	21.1
Price/book value (x)	1.97	1.78	1.35	1.26	1.18	1.94	1.73	1.53	4.65	4.67	4.89
Equity FCF yield (%)	4.54	9.85	-10.5	6.63	2.75	-27.8	7.54	13.2	7.20	8.45	8.60
Normalised PE (x)	6.65	8.34	10.8	8.95	7.24	11.9	9.95	8.81	12.2	11.2	11.3
Norm PE @tgt price (x)	7.96	9.99	12.9	10.7	8.67	15.0	12.6	11.1	14.1	12.9	13.0
Dividend yield (%)	6.84	5.56	6.41	6.84	6.84	3.09	3.76	3.76	7.00	7.62	7.58
					year to Jun			year to Dec			year to Dec

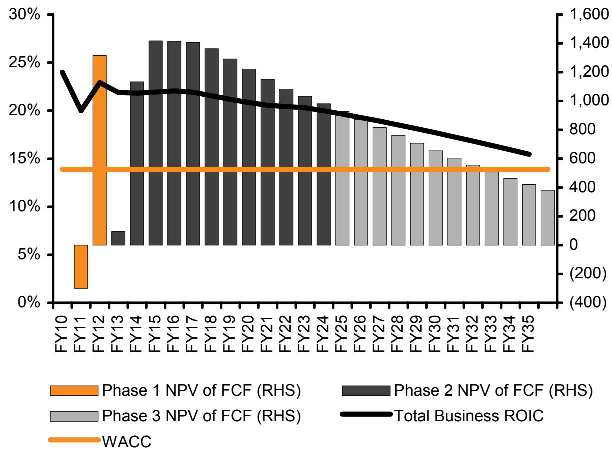
Per share data	**FY08A**	**FY09A**	**FY10F**	**FY11F**	**FY12F**
Tot adj dil sh, ave (m)	170.7	171.2	209.9	222.8	222.8
Reported EPS (INR)	17.6	14.0	10.8	13.1	16.1
Normalised EPS (INR)	17.6	14.0	10.8	13.1	16.1
Dividend per share (INR)	8.00	6.50	7.50	8.00	8.00
Equity FCF per share (INR)	5.31	11.5	-12.3	7.75	3.22
Book value per sh (INR)	59.4	65.5	86.6	92.7	99.5
					year to Jun

Solvency	**FY08A**	**FY09A**	**FY10F**	**FY11F**	**FY12F**
Net debt to equity (%)	-17.7	-21.7	-29.2	-28.2	-20.1
Net debt to tot ass (%)	-5.84	-7.25	-13.6	-13.2	-9.25
Net debt to EBITDA	-0.40	-0.60	-1.73	-1.38	-0.86
Current ratio (x)	1.71	1.57	2.20	2.10	1.96
Operating CF int cov (x)	-111.6	11.6	1.65	-12.8	-9.38
Dividend cover (x)	2.19	2.16	1.39	1.63	2.02
					year to Jun

Priced as follows: HCLI.BO - Rs116.95; 2353.TW - NT$74.50; 2454.TW - NT$493.00
Source: Company data, RBS forecasts

HCL Infosystems – DCF valuation

	DCF - 1-yr fwd
WACC	**13.9%**
NPV of cash flow (2008-2036F)	22,277
Perpetual growth (%)	3.5%
Implied Exit FCF multiple (X)	**10x**
Terminal value	3,784
Enterprise value	**26,061**
Terminal value as % of enterprise value	15%
Net debt	-5,123
Equity value (Rs m)	**31,184**
Number of shares outstanding (diluted)	223
Enterprise value per share (Rs)	117
Equity value per share (Rs)	**140**



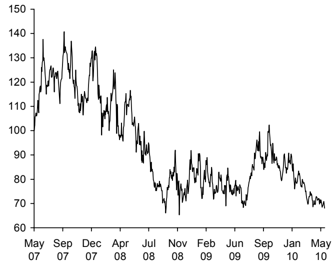
Source: Company data, RBS forecasts

Company description

Buy

HCL Infosystems is a leading vendor of computers in India with a market share of around 10%. Its range of offerings includes computer hardware, systems-integration services, and distribution of technology and telecom products. HCL Infosystems is the primary distributor of Nokia's GSM handsets in India apart from Nokia that directly distributes for roughly half of India.

Price relative to country



Strategic analysis

Average SWOT company score: 3

Strengths — 4

Sole third-party reseller of Nokia's GSM handsets; Nokia has the biggest share of the Indian mobile handset market; a market leader in desktop PC sales, ahead of many MNC vendors; Nokia has a channel base reaching nearly 200,000 outlets.

Weaknesses — 2

High dependence on Nokia handset resale business The Telecom/Office Automation business (in which Nokia accounts for about 90% of revenues) constitutes about 72% of HCL revenues and 63% of segmental EBIT for FY09.

Opportunities — 3

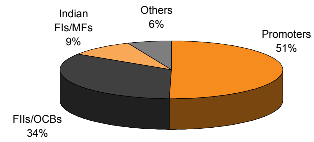
Low PC penetration in India; growth in IT-centric industries is driving hardware demand; rapid growth in mobile telephony - pure-play GSM operators have been adding more than 10m subscribers per month; the domestic IT market presents long-term growth prospects for its System Integration business.

Threats — 1

Emergence of local players that have leveraged the outsourced design/production ecosystem. Competition from MNC players such as HP, Dell, Acer and Lenovo could intensify; reselling arrangement with Nokia is non-exclusive and any additional resellers could significantly impact growth.

Scoring range is 1-5 (high score is good)

Shareholding - March 2010



Source: Company data

Market data

Headquarters
E-4,5,6, Sector 11, NOIDA 201301, U.P., India

Website
www.hcl.in

Shares in issue
222.8m

Freefloat
50%

Majority shareholders
Promoters (50%), Frankin Templeton Investments Funds (8%), HSBC Global Investment Funds (7%)

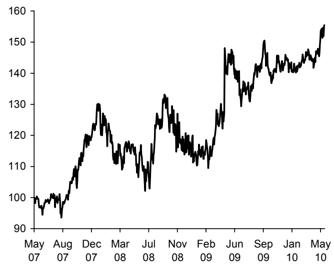
Country view

Underweight

The Indian market underperformed over 1Q10 in local currency terms and we suspect this trend will continue. However, currency strength saw the market outperform in USD. We believe the announced budget represented an opportunity missed for implementation of crucial structural reforms while leaving the central bank even more behind the curve as far as monetary policy is concerned. Thus, the inter-meeting hike was neither a surprise nor a one-off event, in our view. Liquidity conditions therefore, while reasonably benign today (although already past their peak), are likely to tighten going forward. That will matter for a market where an ambitious forward earnings yield ranks much below the prevailing bond yields.

The country view is set in consultation with the relevant company analyst but is the ultimate responsibility of the Strategy Team.

Country rel to Asia Pacific



Competitive position

Average competitive score: 2-

Supplier power — 2+

High in the Nokia handset business, as the relationship is non-exclusive; medium to low in the hardware business.

Barriers to entry — 2-

Maturity of the outsourced production/design ecosystem in Asia has accelerated entry of several new local players, that pose threats to MNC handset brands including Nokia at the lower end.

Customer power — 2-

Highly price-sensitive market. Customer power increasing due to the presence of multiple vendors, with price being the primary differentiator.

Substitute products — 3-

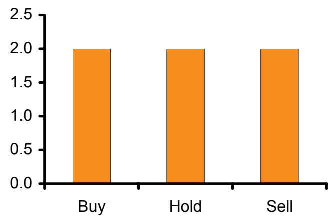
A non-organised market exists for hardware (assemblers). Grey-market handset presence has been coming down due to ban on imports and access to operator networks, replaced by local competition.

Rivalry — 2-

Intense rivalry in both businesses: HP, Dell and Acer have intense focus on the consumer PC market. Local handset players that have launched multi-sim and copycat mobile phones at low prices.

Scoring range 1-5 (high score is good) Plus = getting better Minus = getting worse

Broker recommendations



Source: Bloomberg

Recommendation structure

Absolute performance, short term (trading) recommendation: A Trading Buy recommendation implies upside of 5% or more and a Trading Sell indicates downside of 5% or more. The trading recommendation time horizon is 0-60 days. For Australian coverage, a Trading Buy recommendation implies upside of 5% or more from the suggested entry price range, and a Trading Sell recommendation implies downside of 5% or more from the suggested entry price range. The trading recommendation time horizon is 0-60 days.

Absolute performance, long term (fundamental) recommendation: The recommendation is based on implied upside/downside for the stock from the target price and, except as follows, only reflects capital appreciation. A Buy/Sell implies upside/downside of 10% or more and a Hold less than 10%. For research produced by Nedbank Capital, a Buy implies upside in excess of 20%, A Sell implies an expected return less than 10%, and a Hold implies a return between 10% and 20%. For UK-based Investment Funds research, the recommendation structure is not based on upside/downside to the target price. Rather it is the subjective view of the analyst based on an assessment of the resources and track record of the fund management company. For research produced by Nedbank Capital and for research on Australian listed property trusts (LPT) or real estate investment trusts (REIT), the recommendation is based upon total return, ie, the estimated total return of capital gain, dividends and distributions received for any particular stock over the investment horizon.

Performance parameters and horizon: Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months. Market or sector view: This view is the responsibility of the strategy team and a relative call on the performance of the market/sector relative to the region. Overweight/Underweight implies upside/downside of 10% or more and Neutral implies less than 10% upside/downside. Target price: The target price is the level the stock should currently trade at if the market were to accept the analyst's view of the stock and if the necessary catalysts were in place to effect this change in perception within the performance horizon. In this way, therefore, the target price abstracts from the need to take a view on the market or sector. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted value, the target price will differ from 'fair' value.

Distribution of recommendations

The tables below show the distribution of recommendations (both long term and trading). The first column displays the distribution of recommendations globally and the second column shows the distribution for the region. Numbers in brackets show the percentage for each category where there is an investment banking relationship. These numbers include recommendations produced by third parties with which RBS has joint ventures or strategic alliances.

Long term recommendations (as at 21 May 2010)

	Global total (IB%)	Asia Pacific total (IB%)
Buy	713 (0)	431 (0)
Add	0 (0)	0 (0)
Hold	427 (0)	236 (0)
Reduce	0 (0)	0 (0)
Sell	97 (0)	58 (0)
Total (IB%)	1237 (0)	725 (0)

Source: RBS

Trading recommendations (as at 21 May 2010)

	Global total (IB%)	Asia Pacific total (IB%)
Trading Buy	1 (0)	1 (0)
Trading Sell	0 (0)	0 (0)
Total (IB%)	1 (0)	1 (0)

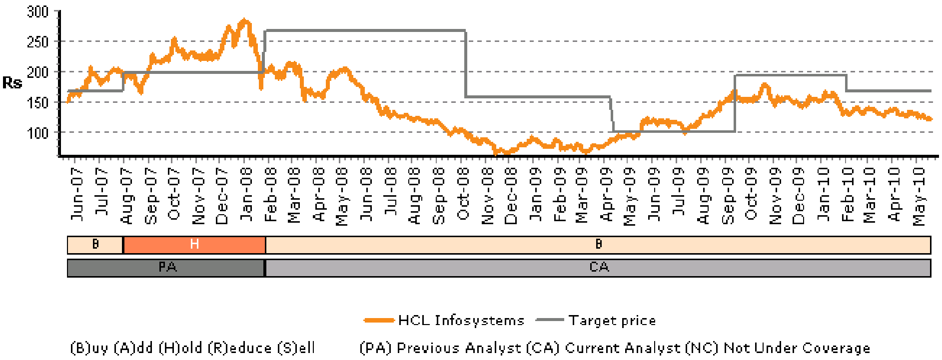
Source: RBS

Valuation and risks to target price

HCL Infosystems (RIC: HCLI.BO, Rec: Buy, CP: Rs116.95, TP: Rs140.00): Key downside risks to our DCF-based target price are: 1) change in the company's contracts with various reselling partners, including Nokia, 2) increased competition in its markets that could affect market share beyond our estimates, 3) a faster-than-expected slowdown in mobile subscriber growth that could negatively impact handset sales, 4) a slowdown in the Indian economy (could affect both enterprise and retail demand), and 5) rupee depreciation (would affect the import costs of key hardware components).

HCL Infosystems coverage data

Stock performance, recommendations and coverage (as at 21 May 2010)



Srinivas Seshadri started covering this stock on 25 Jan 08

Source: RBS

Trading recommendation history (as at 21 May 2010)

Date	Rec	Analyst
	n/a	

Source: RBS

Regulatory disclosures

Subject companies: **HCLI.BO**

RBS beneficially own 1% or more of a class of common equity securities of this company.**: HCLI.BO**

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