

HCL Infosystems

Potential SI business upside largely factored in; We see limited share price upside; Maintain Neutral

- **HCL Infosystems (HCLI) has indicated its desire to raise fresh equity capital largely for investment in System Integration (SI) and acquisitions.** The company has already issued warrants worth Rs 3.22 Bn (dilution of 12%) to promoters. It plans to further issue equity shares through QIP route worth Rs 5Bn (dilution of 19% at current stock price). We review our investment view on the company given queries from investors on the potential upside in HCLI.
- **Key upside in HCLI comes from SI business.** SI currently contributes ~7% to revenues but 20%+ to profits due to higher profitability (~10-15%) compared to HCLI's EBIT margins of ~3%. The business should see a host of projects under Indian government's R-APDRP scheme (Restructured Accelerated Power Development and Reforms Program). With a planned spending of ~Rs100Bn (US\$2.2Bn) over coming 2-3 years, HCLI is one of the 21 empanelled vendors to bid for these projects.
- **However winning these contracts would not be easy** given presence of several large global players (IBM, Accenture, Infosys, TCS and Wipro) and significant competition for other India businesses in recent biddings. Even a modestly optimistic 10% win ratio (i.e. Rs10Bn worth projects) for HCLI would imply yearly growth of ~7-8% on EPS. This is largely factored in our estimates with limited upside if these wins happen.
- **Other segments:** PC segment has seen some recovery with spending from government/PSUs and Indian corporates recovering, while consumer spend is still weak. Nokia business remains steady with increasing proportion of Chinese handsets a potential area of concern. Overall our estimates of 16%/8% revenue CAGR for PC/Nokia business over FY09-11E largely factor in the current market with limited room for upgrades.
- **Investment view:** We expect 15% EPS CAGR over FY09-11E with current FY10E P/E of 10x. While valuations are not demanding, the impending equity dilution, significant risk on award/execution of SI projects, uncertainty on Nokia business beyond 2011 and a business with declining ROEs, we see limited share price upside from current levels.

Reuters: HCLI.BO, Bloomberg: HCLI IN

Rs in millions, year-end June

	FY08A	FY09A	FY10E	FY11E		FY08A	FY09A	FY10E	FY11E		
Sales	126,100	123,829	134,526	150,989	YE BPS (Rs)	59.4	65.5	78.5	90.9	52-Week range	Rs63-171
Oper. Profit	4,227	3,853	4,189	4,806	ROE (%)	32.0	22.4	22.1	21.7	Shares Outstg	171Mn
EBITDA	4,413	4,065	4,429	5,058	ROIC (%)	24.0	19.3	19.3	18.9	Date of price	10/14/2009
Pre Tax Profit	4,299	3,513	4,014	4,640	EPS (Rs)	1Q	2Q	3Q	4Q	Avg daily volume	0.3Mn
Net profit	3,000	2,399	2,730	3,155	EPS (FY08)	4.2	4.8	4.8	3.8	Avg daily value (US\$)	0.6Mn
EPS (Rs)	17.6	14.0	15.9	18.4	EPS (FY09)	3.9	3.2	3.4	3.5	Index (Sensex)	16,214
P/E (x)	8.9	11.1	9.8	8.5	EPS (FY10E)	3.8	3.9	4.1	4.1	Free float	39%
P/B (x)	2.6	2.4	2.0	1.7	Local	1M	3M	12M		Dividend Yld (%)	4.7%
Cash	5,348	4,701	6,382	7,948	Abs. Perf.(%)	-5.9	58.8	62.7		Exchange rate	Rs48.7/US\$1
Gross Debt	3,545	2,268	2,568	2,868	Rel. Perf.(%)	-10.1	25.0	8.1		Market Cap	US\$592.3M
										Target Price (6/2009)	Rs 180

Source: Company data, Bloomberg, J.P. Morgan estimates

Neutral

HCLI.BO, HCLI IN

Price: Rs156.10

Price Target: Rs180.00

India

Indian IT Services

Manoj Singla, CFA^{AC}

(91-22) 6639-3017

manoj.singla@jpmorgan.com

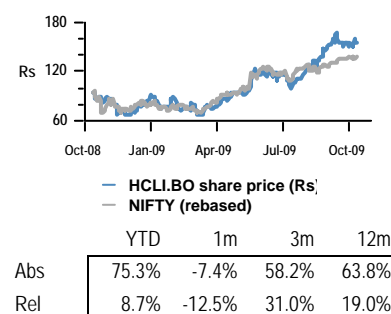
Nishit Jasani

(91-22) 6639-3008

nishit.x.jasani@jpmorgan.com

J.P. Morgan India Private Limited

Price Performance



See page 8 for analyst certification and important disclosures, including non-US analyst disclosures.

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Company Description

HCL Infosystems Limited manufactures computer systems and specializes in the provision of IT solutions and related services. The Company provides a variety of services, including IT consultancy, software development, system integration, SAP consultancy, system support, network implementation and facilities management.

Revenue chart



Source: Company data

EPS: J.P. Morgan vs consensus

	J. P. Morgan	Consensus
FY10E	15.9	17.0
FY11E	18.4	19.3
FY12E	21.5	22.8

Source: Bloomberg, J. P. Morgan estimates

P&L sensitivity metrics

	EBITDA impact (%)	EPS impact (%)
Sales volume growth assumption (FY10E: 8.6%) Impact of each 1%	2.5	2.8
Gross margin assumption (FY10E: 8.9%) Impact of each 20bps	6.1	6.7
Debt/equity assumption (FY10E: 19%) Impact of each 10%	0.0	4.3

Source: J. P. Morgan estimates

Price target and valuation analysis

Our June-10 PT of Rs180 is based on one-year trailing/forward multiple of 12x/10x and PEG of 0.7x, largely inline with medium-term historical trading multiples. Our DCF-based fair value is Rs150 (previously Rs135). Our long-term assumptions are a 10-year revenue CAGR of 10%, long-term EBIT margins of 3%, long-term ROIC of 16% and WACC of 13.7% (15% previously). Our PT assumes a 23% premium over the DCF fair value as the stock is expected to remain firm with PC business recovery.

Risk free rate:	6.5%
Market risk premium:	8.0%
Beta:	0.90
Debt/equity:	0.0%
Cost of debt:	8.0%
Terminal "g":	6.0%

The key downside risks to our PT are lower growth in the PC market, market share loss for Nokia and large equity dilution leading to lower ROE. The key upside risks to our PT are large order wins in SI segment.

Details of R-APDRP IT projects

These projects are for supply, installation and commissioning of one integrated solution including hardware, software, networking, GIS etc to help the power utilities improve their performance. Typical contract would require the IT vendor to maintain the systems for 3 years post installation.

The key responsibilities of the IT vendor would be to act as System Integrator (SI), Network Solution Provider (NSP), GIS Solution Provider (GSP), and Meter Data Acquisition Solution Provider (MDASP).

R-APDRP – Details of the Scheme

Projects under the scheme shall be taken up in two parts – Part A is related to IT projects and Part B is related to modernization of power utilities infrastructure.

Part-A: Projects for establishment of baseline data and IT applications for energy accounting/auditing & IT based consumer service centers.

Funds to be allocated: Rs100Bn.

Project includes preparation of baseline data for the project area covering Consumer Indexing, GIS Mapping, Metering of Distribution Transformers and Feeders, and Automatic Data Logging for all Distribution Transformers and Feeders and SCADA/DMS system. It would include Asset mapping of the entire distribution network at and below the 11kV transformers and other distribution network equipment. It will also include adoption of IT applications for meter reading, billing & collection; energy accounting & auditing; MIS; redressal of consumer grievances; establishment of IT enabled consumer service centres etc.

Part-B: Regular distribution strengthening projects.

Funds to be allocated: Rs 400Bn

Renovation, modernization and strengthening of 11 kV level Substations, Transformers/Transformer Centers, Re-conductoring of lines at 11kV level and below, Load Bifurcation, feeder separation, Load Balancing, HVDS (11kV), Aerial Bunched Conductoring in dense areas, replacement of electromagnetic energy meters with tamper proof electronics meters, installation of capacitor banks and mobile service centres etc.

Funding Mechanism:

Government of India (GoI) will provide 100% Loan for part A of the R-APDRP schemes and up to 25% Loan for Part B of the R-APDRP schemes.

Conversion of GoI Loan to Grant:

The entire amount of GoI loan (100%) for part A of the project shall be converted into grant after establishment of the required Base-Line data system within a stipulated time frame and duly verified.

We believe this incentivisation of converting a GoI loan into a grant for a time-bound adoption of IT systems infrastructure would lead to multitude of projects coming up in a short span of time.

Figure 1: Calendar of events for the IT vendor empanelment for APDRP projects

Event	Date	Time
Begin Sale of RfQ Document	29 th September 2009	-
Clarifications on the RfQ document	08 th October 2009	-
End Sale of RfQ Document	20 th October 2009	3:00 PM
Deadline for submission	20 th October 2009	3:00 PM
RfQ Opening Date	20 th October 2009	3:30 PM

Source: Power ministry, Government of India.

We note that the issuance of RfQ document or qualifying in the final empanelled lists would not mean that the bidder has been awarded any project. Each utility shall follow bidding process to select and appoint the System Integrator. The SI may choose to sub-contract part of the work – which means HCL Infosystems could get part of the projects even if it doesn't win the project outright as the sub-contractors have to be from the empanelled list of NSP, GSP, and MDASP.

Valuation – Jun-10 price target of Rs180

Our June-10 PT of Rs180 is based on one-year trailing/forward multiple of 12x/10x, largely inline with medium-term historical trading multiples. Our DCF-based fair value is Rs150 with long-term assumptions of 10-year revenue CAGR of 10%, long-term EBIT margins of 3%, long-term ROIC of 16% and WACC of 13.7%. Our PT assumes a 23% premium over the DCF fair value as the stock is expected to remain firm with PC business recovery.

The key downside risks to our PT are lower growth in the PC market, market share loss for Nokia and large equity dilution leading to lower ROE. **The key upside risks** to our PT are large order wins in SI segment.

Table 1: Growth in Telecom and PC segments

Rs in millions, year-end June

	FY06	FY07	FY08	FY09	FY10E	FY11E	FY12E
Computer Systems (Rs MM)	23,783	27,846	33,936	35,004	40,574	47,482	55,608
Y/Y growth %	20.9	17.1	21.9	3.1	15.9	17.0	17.1
Segment profit	1,256	1,743	1,996	1,773	1,948	2,374	2,892
Segment margin %	5.3	6.3	5.9	5.1	4.8	5.0	5.2
Telecom (Rs MM)	90,498	90,495	92,228	89,186	94,592	104,147	116,107
Y/Y growth %	56.6	(0.0)	1.9	(3.3)	6.1	10.1	11.5
Segment profit	2,440	2,671	2,855	2,462	2,459	2,708	3,019
Segment margin %	2.7	3.0	3.1	2.8	2.6	2.6	2.6
Total	114,519	118,555	126,100	123,829	134,526	150,989	171,075
Y/Y growth%	47.1	3.5	6.4	(1.8)	8.6	12.2	13.3
EBIT	3,649	3,886	4,227	3,853	4,189	4,806	5,568
EBIT Margin	3.2	3.3	3.4	3.1	3.1	3.2	3.3

Source: Company data, J.P. Morgan estimates.

We expect revenues in the PC segment to increase by ~16% in FY10 with weakness in consumer PC being offset by enterprise business recovering and improvement in SI revenues.

We have maintained our telecom segment estimates with conservative margin estimates.

Table 2: HCLI P&L

Rs in millions, year-end June

Earnings Model	FY09				FY10E				FY07	FY08	FY09	FY10E	FY11E	FY12E
	1Q	2Q	3Q	4Q	1QE	2QE	3QE	4QE						
Revenue	30,861	31,401	30,238	31,329	32,339	33,063	34,166	34,958	118,555	126,100	123,829	134,526	150,989	171,075
Gross Profit	2,720	2,652	2,703	2,607	2,889	2,945	3,044	3,113	8,694	10,511	10,682	11,992	13,563	15,490
EBIT	1,129	937	988	799	1,014	1,028	1,063	1,085	3,886	4,227	3,853	4,189	4,806	5,568
EBITDA	1,176	987	1,044	858	1,073	1,087	1,123	1,146	4,035	4,413	4,065	4,429	5,058	5,832
Pre Tax Profit	960	810	895	848	967	985	1,020	1,042	4,285	4,299	3,513	4,014	4,640	5,419
Net Profit	661	553	581	604	658	670	694	709	3,157	3,000	2,399	2,730	3,155	3,685
EPS (Rs)	3.9	3.2	3.4	3.5	3.8	3.9	4.1	4.1	18.7	17.6	14.0	15.9	18.4	21.5
Margins (%)														
Gross Margin	8.8	8.4	8.9	8.3	8.9	8.9	8.9	8.9	7.3	8.3	8.6	8.9	9.0	9.1
Operating Margin	3.7	3.0	3.3	2.6	3.1	3.1	3.1	3.1	3.3	3.4	3.1	3.1	3.2	3.3
EBITDA Margin	3.8	3.1	3.5	2.7	3.3	3.3	3.3	3.3	3.4	3.5	3.3	3.3	3.3	3.4
Net Margin	2.1	1.8	1.9	1.9	2.0	2.0	2.0	2.0	2.7	2.4	1.9	2.0	2.1	2.2
Seq. Growth (%)														
Revenue	(2.2)	1.7	(3.7)	3.6	3.2	2.2	3.3	2.3	3.5	6.4	(1.8)	8.6	12.2	13.3
Gross Profit	5.9	(2.5)	1.9	(3.6)	10.8	1.9	3.4	2.2	13.9	20.9	1.6	12.3	13.1	14.2
EBIT	11.2	(17.0)	5.5	(19.1)	26.9	1.4	3.4	2.1	6.5	8.8	(8.9)	8.7	14.7	15.9
EBITDA	10.5	(16.1)	5.8	(17.8)	25.0	1.4	3.3	2.0	7.0	9.4	(7.9)	8.9	14.2	15.3
PBT	0.5	(15.6)	10.5	(5.3)	14.1	1.8	3.6	2.2	11.8	0.3	(18.3)	14.3	15.6	16.8
Net Profit	1.5	(16.4)	5.2	4.0	8.9	1.8	3.6	2.2	13.4	(5.0)	(20.1)	13.8	15.6	16.8
EPS	1.5	(16.4)	5.1	4.0	8.9	1.8	3.6	2.2	11.9	(5.9)	(20.3)	13.8	15.6	16.8

Source: Company data, J.P. Morgan estimates.

HCL Infosystems: Summary of financials

Rs in millions, year-end June

Income statement						Ratio Analysis					
INR in millions, year-end June	FY08	FY09	FY10E	FY11E	FY12E	% , year-end June	FY08	FY09	FY10E	FY11E	FY12E
Revenues	126,100	123,829	134,526	150,989	171,075	Gross Margin	8.3	8.6	8.9	9.0	9.1
Cost of Goods Sold	115,589	113,147	122,534	137,425	155,584	EBITDA margin	3.5	3.3	3.3	3.3	3.4
Gross Profit	10,511	10,682	11,992	13,563	15,490	Operating Margin	3.4	3.1	3.1	3.2	3.3
SG&A Expenses	6,284	6,829	7,803	8,757	9,922	Net Margin	2.4	1.9	2.0	2.1	2.2
						SG&A/Sales	5.0	5.5	5.8	5.8	5.8
Operating Profit (EBIT)	4,227	3,853	4,189	4,806	5,568						
EBITDA	4413	4065	4429	5058	5832						
Interest Income	-	-	-	-	-	Sales growth	6.4	-1.8	8.6	12.2	13.3
Interest Expense	(398)	(407)	(393)	(442)	(492)	Operating Profit Growth	8.8	-8.9	8.7	14.7	15.9
Investment Income (Exp.)	-	-	-	-	-	Net profit growth	-5.0	-20.1	13.8	15.6	16.8
Non-Operating Income (Exp.)	470	67	218	276	342	EPS (Reported) growth	-5.9	-20.3	13.8	15.6	16.8
Earnings before tax	4,299	3,513	4,014	4,640	5,419						
Tax	-1,299	-1,114	-1,285	-1,485	-1,734	Interest coverage (x)	10.6	9.5	10.7	10.9	11.3
Net Income (Reported)	3000	2399	2730	3155	3685	Net debt to total capital	n.m.	n.m.	n.m.	n.m.	n.m.
Net Income (Adjusted)	3000	2399	2730	3155	3685	Net debt to equity	n.m.	n.m.	n.m.	n.m.	n.m.
INR											
EPS (Reported)	17.6	14.0	15.9	18.4	21.5	Asset Turnover	4.1	3.7	3.5	3.5	3.4
EPS (Adjusted)	17.6	14.0	15.9	18.4	21.5						
BPS	59.4	65.5	78.5	90.9	106.5	ROE	32.0	22.4	22.1	21.7	21.8
DPS	8.0	6.5	6.0	6.0	6.0	ROIC	24.0	19.3	19.3	18.9	19.0
Shares Outstanding (mn)	171	171	171	171	171	ROCE	24.0	19.3	19.3	18.9	19.0
Balance sheet						Cash flow statement					
INR in millions, year-end June	FY08	FY09	FY10E	FY11E	FY12E	INR in millions, year-end June	FY08	FY09	FY10E	FY11E	FY12E
Cash and cash equivalents	5,348	4,701	6,382	7,948	9,768	Net Income	3,000	2,399	2,730	3,155	3,685
Accounts receivable	12,481	15,063	16,808	18,846	21,494	Depr. & Amortisation	186	213	240	252	264
Loans and Advances	0	0	0	0	0	Change in working capital	-1,910	-272	-943	-974	-1,260
Others	11,372	11,952	13,336	14,954	17,055	Other	0	0	0	0	0
Current assets	29,201	31,716	36,526	41,748	48,317	Cash flow from operations	1,276	2,339	2,027	2,433	2,688
LT investments	0	0	0	0	1	Capex	-372	-367	-140	-140	-140
Net fixed assets	1,698	1,852	1,752	1,641	1,517	Disposal/ (purchase)	0	0	0	0	0
Others	0	0	0	0	0	Cash flow from investing	-372	-367	-140	-140	-140
Total assets	30,899	33,568	38,278	43,388	49,835	Free cash flow	904	1,973	1,887	2,293	2,548
Liabilities						Equity raised/ (repaid)	-69	-229	521	0	0
ST loans	0	0	0	0	0	Debt raised/ (repaid)	1,186	-1,277	300	300	300
Payables	17,125	20,138	22,331	25,020	28,518	Other	0	0	0	0	0
Others	67	-56	-62	-70	-80	Dividends paid	-1,366	-1,113	-1,027	-1,027	-1,027
Total current liabilities	17,192	20,082	22,268	24,950	28,439	Cash flow from financing	-249	-2,619	-206	-727	-727
Long term debt	3,545	2,268	2,568	2,868	3,168						
Other liabilities	0	0	0	0	0	Net change in cash	655	-646	1,680	1,566	1,820
Total liabilities	20,737	22,350	24,836	27,818	31,607	Beginning cash	4,692	5,348	4,701	6,382	7,948
Shareholders' equity	10,162	11,219	13,442	15,570	18,227	Ending cash	5,347	4,702	6,381	7,948	9,768

Source: Company reports, J.P. Morgan estimates.

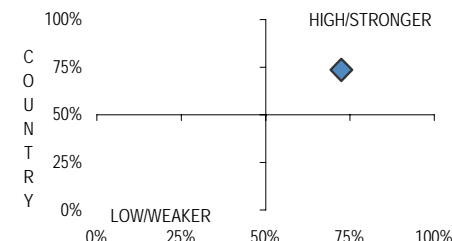
All Data As Of 12-Oct-09

Q-Snapshot: HCL Infosystems Ltd.

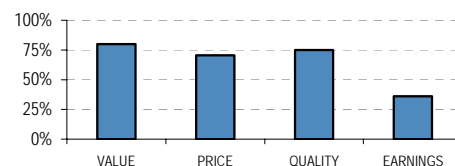
Quant Return Drivers (a Score >50% indicates company ranks 'above average')

Score 0% (worst) to 100% (best)	vs Country	vs Industry	Raw Value
Value			
P/E Vs Market (12mth fwd EPS)	79%	85%	0.6x
P/E Vs Sector (12mth fwd EPS)	87%	83%	0.5x
EPS Growth (forecast)	50%	54%	18.5%
Value Score	80%	86%	
Price Momentum			
12 Month Price Momentum	59%	62%	70.6%
1 Month Price Reversion	85%	72%	-4.0%
Momentum Score	71%	69%	
Quality			
Return On Equity (forecast)	75%	70%	23.5%
Earnings Risk (Variation in Consensus)	63%	41%	0.10
Quality Score	75%	61%	
Earnings & Sentiment			
Earnings Momentum 3mth (risk adjusted)	38%	49%	22.0
1 Mth Change in Avg Recom.	4%	3%	-0.33
Net Revisions FY2 EPS	95%	92%	100%
Earnings & Sentiment Score	36%	37%	
COMPOSITE Q-SCORE* (0% To 100%)	74%	73%	

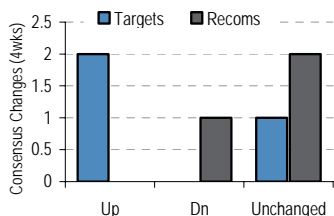
J.P. Morgan Composite Q-Score



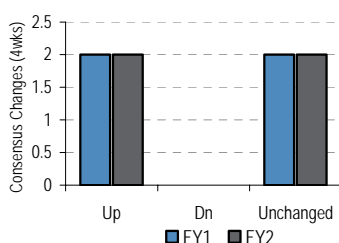
Quant Return Drivers Summary (vs Country)



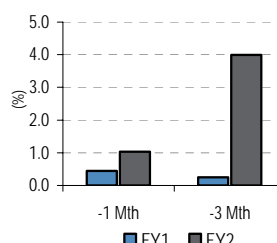
Targets & Recommendations**



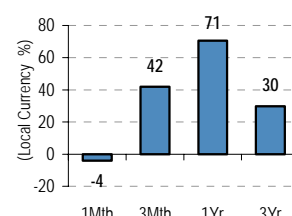
EPS Revisions**



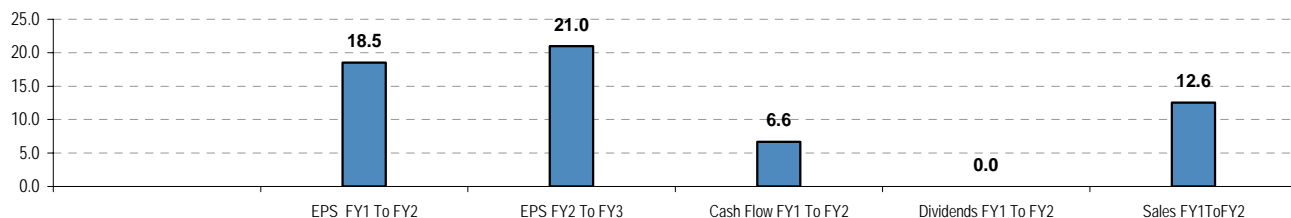
EPS Momentum (%)



Historical Total Return (%)



Consensus Growth Outlook (%)



Closest in Country by Size (Consensus. ADV = average daily value traded in US\$m over the last 3 mths)

Code	Name	Industry	USD MCAP	ADV	PE FY1	Q-Score*
531120-IN	Patel Engineering Ltd.	Engineering & Construction	603	0.64	17.4	75%
532714-IN	KEC International Ltd.	Engineering & Construction	603	0.16	14.6	64%
500260-IN	Madras Cements Ltd.	Construction Materials	596	0.70	6.2	37%
532691-IN	Tulip Telecom Ltd.	Information Technology Services	582	1.27	10.3	51%
532944-IN	OnMobile Global Ltd.	Specialty Telecommunications	572	0.77	28.3	19%
500179-IN	HCL Infosystems Ltd.	Information Technology Services	572	0.33	9.7	74%
500680-IN	Pfizer Ltd.	Pharmaceuticals: Major	567	0.16	17.7	26%
531162-IN	Emami Ltd.	Household/Personal Care	565	0.26	21.1	
523838-IN	Simplex Infrastructures Ltd.	Engineering & Construction	554	0.14	16.8	52%
500420-IN	Torrent Pharmaceuticals Ltd.	Pharmaceuticals: Major	548	0.22	10.7	94%
532780-IN	Parsvnath Developers Ltd.	Real Estate Development	547	1.78	24.9	51%

Source: Factset, Thomson and J.P. Morgan Quantitative Research. For an explanation of the Q-Snapshot, please visit <http://jpmorgan.hk.acrobat.com/qsnapshot/>
Q-Snapshots are a product of J.P. Morgan's Global Quantitative Analysis team and provide quantitative metrics summarized in an overall company 'Q-Score.'
Q-Snapshots are based on consensus data and should not be considered as having a direct relationship with the J.P. Morgan analysts' recommendation.
* The Composite Q-Score is calculated by weighting and combining the 10 Quant return drivers shown. The higher the Q-Score the higher the one month expected return. On a 14 Year back-test the stocks with the highest Q-Scores have been shown (on average) to significantly outperform those stocks with the lowest Q-Scores in this universe. ** The number of up, down and unchanged target prices, recommendations or EPS forecasts that make up consensus.

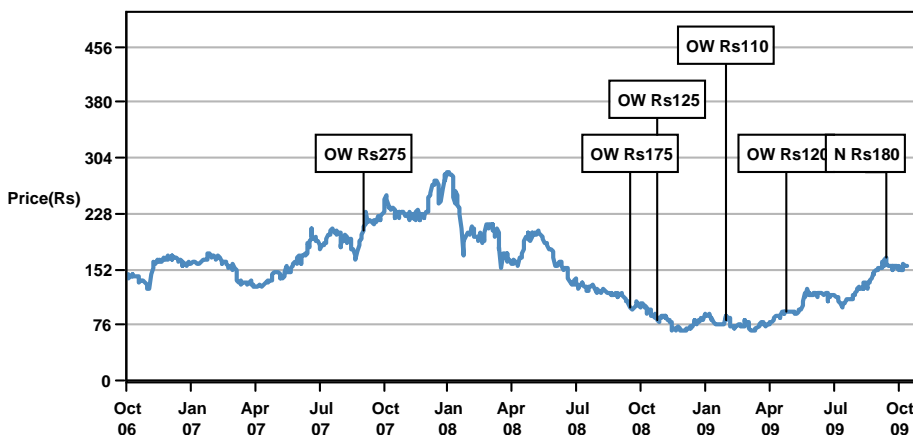
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HCL Infosystems (HCLI.BO) Price Chart



Date	Rating	Share Price (Rs)	Price Target (Rs)
03-Sep-07	OW	205.85	275.00
16-Sep-08	OW	100.25	175.00
25-Oct-08	OW	81.95	125.00
30-Jan-09	OW	83.80	110.00
26-Apr-09	OW	93.85	120.00
14-Sep-09	N	168.55	180.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
 This chart shows J.P. Morgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
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IB clients*	56%	57%	42%
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IB clients*	76%	72%	56%

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