“Quarterly Investors Call of HCL Infosystems Limited”

May 15th, 2013

SPEAKER: **Management**

Management: Let us begin with a discussion on our business highlights and lowlights for the third quarter - Q3 JFM'13. The lowlights included a steep decline in top line on some of our segments which is a result of three headwinds.

The first headwind was a drop in our telecom distribution business. In the last quarter, there was a 25% quarter-on-quarter decline in the telecom distribution revenues. The decline followed a 17% quarter-on-quarter decline in Q2. This is the second consecutive quarter with a significant drop in the volumes of our telecom distribution business. This essentially is due to Nokia's current portfolio transition which includes the shift from the Symbian Operating System (OS) to Windows 8 OS on their phones. The Asha low-end feature phone portfolio is also under transition. The portfolio revamp is expected to continue in the remaining part of the calendar year also. Nokia has so far announced about five new phones in the Lumia range and two new Asha phones. An equal number of phones are expected to be launched in the feature phone as well as the high-end smartphone category in the remaining part of the year. Till the time these launches materialise, Nokia would not have a full portfolio which will cover each price-point category. Due to these reasons there was a subdued performance in our telecom distribution business. Post its 25% q-o-q drop, the business continued with a low level of performance. However the good news is that there is no further drop in the business. It has stabilized at a lower volume which today stands at about Rs. 325 crores a month, and hence about Rs. 950 to Rs. 1,000 crores a quarter.

The second headwind is primarily due to the Computing hardware industry facing a global de-growth in the last quarter. As per an IDC report, in the last quarter, global computing hardware business de-grew by 15% quarter-on-quarter. Similar headwinds were witnessed in the Indian computing hardware industry and as a result significant sequential de-growth impacted our computing hardware business.

In our System Integration (SI) Projects business, we have a significant order backlog. This business can have a quarter-on-quarter swing resulting from the achievement or non-achievement of certain milestones within the timeline of the quarter. We had a significant revenue recognition because of the UIDAI programme in Q2FY13. In comparison, some milestones were achieved in Q3 FY13, but they did not impact our revenues to the same degree. And hence, on a quarter-on-quarter basis, the System Integration business showed a decline.

Regarding our Highlights our big growth areas continued to show a very good quarter-on-quarter growth.

Our Enterprise Services business grew 11% quarter-on-quarter, the Tablet business grew 50% quarter-on-quarter, the IT distribution and Digital Entertainment distribution business grew 34% quarter-on-quarter and our learning portfolio grew 30% quarter-on-quarter.

Our Managed Services business, which is a part of our Enterprise Services business, signed a number of contracts. The ACV (Annual Contract Value), which is a good lead indicator of business volumes going forward, increased from Rs. 70 crores as on 1st July 2012, to Rs. 170 crores as on March 2013. These gains will translate to revenues in the next 12 months.

We have been very selective in our SI business due to issues regarding customer credit worthiness and delays in project milestone sign offs and project completions. So being selective and by meeting all our threshold criteria we have been able to book two orders of about Rs. 600 crores value in the last quarter. These two orders have taken our SI order backlog back to about Rs. 4,000 crores, which will give us a good revenue visibility in the SI business for the next 4 to 5 years.

So on the whole, there was good momentum on our growth areas but our traditional hardware business and telecom distribution business faced continued severe headwinds.

We will now take a deeper perspective on each of the businesses.

Our Telecom Distribution business shrank from Rs. 1,276 crores in Q2 FY13 to Rs. 955 crores in Q3 FY13. On the other hand, Digital Entertainment and the IT distribution business grew 34% sequentially from Rs. 145 crores in the quarter to Rs. 194 crores.

In this quarter, we also have signed on many more logos which will translate to additional revenue as the business ramps up. These new logos includes Molex, Huawei and ZTE for networking and data card products, Tyco for structure cabling, Penta and Simmtronics tablets with different price points, IT components such as Viewsonic and UPS from Su-Kam. So, we have been able to expand our non-telecom distribution portfolio to reduce dependence on one large category in the business and which is also registering a very good quarter-after-quarter growth.

In the Enterprise Solutions business, each segment declined from the last quarter. This can be attributed to the continued drop in capital spend by the Government and large enterprises. BFSI is the only vertical that has been continuing to spend at a good pace. All other verticals like Telecom, Utility, Manufacturing have showed decline in customer spend for large IT projects. And hence, enterprise solutions business registered a steep decline.

In the previous quarter, Q2 FY13, Rs. 591 crores of Enterprise Hardware revenue included a large portion of ELCOT order of Rs. 273 crores from the State Government of Tamil Nadu.

However, the ELCOT order had a loss for us because it was booked when the exchange rate was lower. And we had to renegotiate the execution to bring it to a level where we could execute and minimise the loss. It was a profitless order executed in Q2 FY13 due to contract considerations. Hence, Enterprise Hardware business as a whole, showed improvement in EBIT performance despite having a drop in revenue in Q3 FY13,

Our System Integration business moved from Rs. 267 crores to Rs. 213 crores. The entire swing is largely on account of timing of various milestones. The business continues to perform well and as per our EBIT expectations. However, a particular milestone can make one quarter a little more healthy in comparison to some other quarters.

We have booked Rs. 600 crores worth of orders in our SI business. These include an order from Army, Defence Communication Network, e-Public Distribution System project from a state government and certain enterprise application projects.

However overall Profitability performance of Enterprise Solution as a segment continues to be significantly muted due to our overdue bills receivable position in this business.

In the last quarter, we made significant impairment provision of Rs. 23 crores towards doubtful debts. This largely is related to our orders booked & billed during the period of 2008 to 2010. However, we will continue with our efforts to recover the bad debts. The Rs. 23 crores of provision in Q3 FY13 is in addition to the Rs. 21 crores of provision considered in Q2 FY13 period.

The profitability of our Solutions business was also impacted by rising interest costs because of our receivables being stuck in some of our SI projects. Today, our interest cost is at Rs. 37 crores a quarter and that has also impacted the performance of our enterprise solutions business.

In our services part of the business, Enterprise Services grew at 11%. Growth was largely driven by our performance in the Managed Services segment. We have signed ten large deals in India and three significant wins were achieved from various government agencies in Singapore. As I have mentioned earlier, our ACV (Annual Contract Value) of managed services contract grew in three quarters from Rs. 70 crores to Rs. 170 crores giving a significant revenue visibility to our managed services business over the next year.

On the other hand, our Consumer Care business was impacted because of a drop in our Telecom distribution business. For the products that we sell in our Telecom distribution, we also service and do a warranty repair at the repair factory in our Care business. Steep decline in the volume of phones sold in our Telecom distribution business was also mirrored in terms of lower volume of warranty service and repair volume for our Care Business. And the business saw a drop in revenue from Rs. 19 crores in the prior quarter to Rs. 17 crores this quarter.
But notwithstanding that drop we were able to add additional logos for consumer electronic service support in our Care business. We won support contracts from Samsung, ZTE and also started shop in shops for consumer service in TMS mobile stores across various parts in the country.

We also started a pilot of HCL 'Touch' stores, which is a multi-brand consumer electronic service centre as a new concept. Through a pilot in NCR, we have started with eight centres and plan to expand to 35 centres before the end of this quarter. These centres will provide service to different brands of IT, Telecom and consumer electronic items. These centres will be walk-in centres where a consumer could bring his product to get repair and warranty support.

In our mobility and consumer computing business, both mobility and consumer computing put together continued to show a healthy growth quarter-on-quarter. But the growth is majorly driven through our Tablets which in fact have recorded a 50% growth quarter-on-quarter. Our Tablet business grew from Rs. 50 crores to Rs. 75 crores in the last quarter which compensated a drop in consumer computing from Rs. 106 crores to Rs. 97 crores. The Tablets are essentially eating into our consumer computing market as a category and that trend is being witnessed globally in the consumer computing segment and we are observing the same trend in India as well. The form factor is changing and moving from desktop form factor or a laptop form factor to a mobile device form factor. And we are witnessing that in the performance of these two divisions.

Part of the growth in our mobility business was also driven by growth in Middle East and Africa. The Brand continued to be one of the top-three Tablets selling in most of the countries in the Middle East. We also launched our business in this quarter in Turkey.

Our Learning business as we had mentioned last time, is a very cyclical business and a lot of this business essentially gets decided when the new educational year begins. A lot of business purchase happens from schools and colleges from February to June. And in line with that cyclicality, we did see a revenue growth of 33% quarter-on-quarter in the Learning business which grew from Rs. 14 crores to Rs. 18 crores. We have now crossed 3,000 schools. Our DigiSchool solution is present in 3,000 schools and we are touching close to 3 million students. We have also introduced early in the last quarter our B2C content. Now content that is taught in schools, is also available on Tablets and Dongles so that there is a learning continuum for students. Students can now refresh whatever they have studied in the school and also follow up through their homework. We have also introduced this offering now to some schools and a couple of organised trade retail chains. In the last quarter, we have taken our content to the schools in the Middle East and Africa as well.

So to give an overall perspective, revenue dropped from Rs. 2,606 crores to Rs. 2,095 crores. All of these translated into a consolidated profit movement from a loss of Rs. 52 crores, in Q2 to a loss of Rs. 20 crores in Q3.

Adding back the impairment provision considered in Q2, our pre-tax loss before impairment was Rs. 31 crores in Q2. Consumer computing and mobility added Rs. 11 crores in pre-tax profit both from extra volumes in mobility as well as extra margins on consumer computing. While consumer computing showed drop in volumes, margins improved as we became even more selective and also carried out significant cost take-out actions in the quarter that will be shared later in the presentation.

Enterprise hardware showed an improvement of Rs. 10 crores to the bottom line. This largely came out of the elimination of loss making order of ELCOT in Q2, which was no longer there in Q3. Services business added Rs. 4 crores on quarter-on-quarter basis to bottom line largely driven by a growth of volumes. Learning business, added Rs. 3 crores improvement in bottom line both on account of growth in volume as well as margin expansion. Learning business, in fact, as an industry is going through a consolidation phase. Aggression that was evident in the market a year back to just add classrooms and increase the classroom time is now going down and every player is focusing on stabilising and consolidating their business and looking at actually improving their balance sheet. As result of this step the gross margins in this business have shown 400 basis points improvement over the last quarter.

Our Net borrowing cost went down by Rs. 6 crores, although interest went up. The additional income from lease of computing hardware assets to schools and to enterprises like BHEL, has mitigated the increase in cost on account of a higher borrowing cost.

Reduction in other SG&A as a part of overall cost reduction effort contributed Rs. 8 crores to the bottom line improvement. Other income from disposal of a plant in Chennai & some of the other idling assets resulted in a gain of Rs. 6 crores for the quarter.

Volume drop in telecom distribution took away Rs. 5 crores;

Thus, a loss before impairment of Rs. 31 crores in Q2 actually moved to profit before impairment of Rs. 4 crores in Q3. This is Rs. 35 crores of improvement in the quarter despite having a significant drop in volumes.

So the one big news or one big story for the quarter was a significant operational improvement on account of discipline in certain businesses as well as a cost take-out action that we had done in all the businesses. Rs. 4 crores of PBT before impairment provision then reduced by an impairment provision for the quarter of Rs. 23 crores, on account of all receivables that are yet to be collected, meant a pre-tax loss of Rs. 20 crores reported on a consolidated basis.

I would like to now give an update on our focus areas that we had shared with you in our last few analyst webcasts. The first focus area for the company continues to be growth of our services in both enterprise and consumer space. Our Enterprise part is showing good results, with a 11% growth on quarter-on-quarter basis; however, the Consumer business did not grow as expected although new logos got signed up for our consumer care business. The gains made in the consumer care business was more than negated by a drop in the Nokia repair factory volumes.

The second focus area is the growth of our distribution business through additional brands in digital entertainment and IT. In the multi brand distribution space a number of new partners were added with a 34% growth quarter-on-quarter in IT & Consumer electronics distribution

The third focus area has been growing our learning portfolio. In the last quarter, we grew 33% quarter-on-quarter in learning business. However, on year-on-year basis, the business growth has moderated due to consolidation across the industry. The good news how ever is that the margins have gone up.
The last focus area was ramp-up in the UIDAI managed services programme. So far we have done Rs. 244 crores of revenue in the program. We have a team size of about 700 people working full time on this project and the project is moving along at a smooth pace and is on track to deliver the expected results.

I would also like to give you a quick update on the restructuring of our business that we had announced earlier in the quarter. We had announced that HCLI is reorganising its diverse business into different subsidiaries. For computing and mobility, we had announced a subsidiary a year back - HCPL (HCL Computing Products Limited). We had also announced formation of subsidiary called DDMS (Digilife Distribution & Marketing Services) over a year back for our multi brand distribution business. And then we had announced three more subsidiaries for our other different businesses namely - solutions, services and learning. So at the end of this restructuring exercise, we expect different businesses with different business models operating through different subsidiaries.

The restructuring plan was announced essentially to give enhanced operational and financial freedom to each of these different businesses and give a sharp focus on doing the right things for the growth businesses. For example the momentum for a particular business might require investment on the other hand, the focus on our hardware and solution business might be to create efficiency and a leaner structure.

There are different challenges and opportunities in front of our diverse businesses and this new structure would give more focus, operational flexibility and freedom to grow the businesses.

We have filed a scheme of arrangement with the stock exchange and SEBI for their approval which is now expected any day. As soon as we get this approval, we would go ahead and file the scheme with the High Court for subsequent steps. We will keep you updated with progress on this scheme from time to time.

While the process of creating the subsidiaries continues, we are focussing on the businesses for significant cost takeouts and we have continued with our cost optimization actions.

In hardware and solutions part of the business, we have executed cost optimization actions contributing to Rs. 40 crores of cost savings on an annualised basis. As many of these actions have their lead time, most of the resultant effect will be seen in subsequent quarters.

In addition to this first phase of cost takeouts, we have kick started Phase-2 of our cost optimization actions this quarter of about Rs. 15 crores on an annualised basis. So we are well on our path to create a leaner, more focused structure for our five different business models. We have started right sizing and creating a leaner organisation to make each of the subsidiaries viable and self-sustaining.

This was the quarterly update from our side. Please feel free to raise any questions. As you can see on your screen, there is a toll-free number for you to raise your questions. Let us throw the session open for any Q&A.

Moderator: Participants who have joined the conference on audio line, you can press "0" and "1" on your telephone keypad and wait for your name to be announced. Participants who have joined the conference on audio line, you can press "0" and "1" on your telephone keypad and ask your question over the phone. Participants who have joined the conference on audio line, you can press "0" and "1" on your telephone keypad and wait for your name to be announced.

There is a question coming from the audio line from Mr. Rishindra Goswami of Locus Investment. Mr. Goswami, your line is unmuted now.

Rishindra Goswami: What was the consolidated PBT of the distribution business for the quarter? What would be the PBIT?

The segments reported are for the standalone distribution business. Are there some parts, which sit outside the standalone entity as well.

Management: Rs. 19.7 crores was the consolidated PBIT for the distribution business for the quarter. The revenue from Digital Entertainment business (DDMS) grew from Rs. 145 crores to Rs. 195 crores This revenue is not counted in the stand alone results but forms a part of consolidated numbers for distribution business.

Rishindra Goswami: What was the reason for FOREX loss? Some earlier contracts would have wound out by now and the currency has been fairly stable on the quarter-on-quarter basis.

Management: Gain or loss is due to two movements. The first movement is due to hedging, this is amortized over the period of the hedge. For example, if a hedge is bought with the premium of three rupees for six months duration, this is amortized over 6 months. The second movement is mark-to-market movement. As the currency was stable from the start of the quarter to the end of the quarter, most of the FOREX loss was due to amortization of the hedges.

In the period of high volatility, we adopt a higher coverage method keeping significant part of exposure hedged. This creates an amortization impact quarter after quarter.

Rishindra Goswami: And will this continue in this quarter?

Management: Yes, it will continue. How ever it may go down as some of the high cost hedges expire. Right now, it is running at Rs. 6 crores a quarter. How ever, there could be an impact of mark to market adjustments, should there be a movement in Forex rate during the quarter..

Rishindra Goswami: And any more contract on books or under delivery, which will have a negative impact from the FOREX side?

Management: No. ELCOT was the large contract, which had its big swing.

Now, there are no contracts on the books, with negative gross margin due to sharp swing in FX rates.

Rishindra Goswami: So, that is all done?

Management: Yes, that is all done.

Rishindra Goswami: What is the total debt on books currently?

Management: Total loan is Rs. 1283 crores.

Rishindra Goswami: That would be everything, including all debts?

Management: Yes, We have loans of Rs. 1283 crores, the Investments and Cash & Bank balances, are Rs. 1129 crores, end of the quarter. So, net debt of Rs. 160 crores.

Rishindra Goswami: About Rs. 160 crores. But the net debt level has been rising from the June year-end numbers. Despite some cash flow production; the debt level has gone up.

Management: Yes.

Rishindra Goswami: What would explain this?

Management: Operational free cash flow for the nine months period has been negative.

Rishindra Goswami: The cash from operations being negative for nine months is primarily coming from the working capital side. Is that Right?

Management: I would like to answer in two parts, firstly on a nine month period has loss on the books. Free cash flow which is profit plus depreciation plus change in working capital. Bulk of negative free cash flow is coming out of the loss.

Secondly, on the working capital side, the receivables had remained flat. The decline in telecom distribution business in the last two quarters, lead to higher inventory levels.

Most of the negative operating free cash flow essentially came partly out of the loss and partly out of the inventory build-up in Telecom distribution business.

Rishindra Goswami: But the debtor as you said is more or less flat over nine months period. That hasn't moved.

Management: Right, the debtor level hasn't moved significantly

Rishindra Goswami: Okay. Is there any progress on collecting some of the earlier receivables - any movement there?

Management: The receivables from state-owned enterprises (BSNL, MTNL, ITI and some state discoms), which now are in a very difficult financial position, are moving but at a slow pace. We are in dialogue with these customers to recover our receivables.

They are paying at a very slow pace and not at a pace which we need to collect to liquidate these old receivables.

Provision made for doubtful debts during the quarter was Rs 23 cr (total provision now in balance sheet at Rs 125 Cr) We do believe that some of this provision is still recoverable and hence we are still in discussion with the concerned customer. In few cases / contracts we are also in the process arbitration to recover some of these amounts.

Rishindra Goswami: I think that will be all from my side. Thank you.

Management: Thank you.

Moderator: Thank you, Mr. Goswami. There is another question coming from Mr.Govind Agarwal of JM Financials. Mr. Agarwal, your line is unmuted now. You can go ahead and ask.

Govind Agarwal: Hi Sir, good afternoon. Can you share the outlook on the SI business going forward? And also the second question is, are we taking any litigation steps to avoid contracts like ELCOT contract in which we have lost in the last two quarters?

Management: The SI business encountered difficulties about 18 or 21 months back, as the projects with BSNL, MTNL and ITI did not move as desired.

Since then tight controls were introduced on the kind of bids that we would participate in and pursue. Stringent thresholds were put in terms of profit margin in any business in terms of IRR, cash flow and average ROI over the life of the contract. To participate a bid all this three thresholds needed to cleared.

Also a blacklist of customers was created that are out of bounds for our sales persons. The credit control division keeps revising this list every quarter.. SI projects bid through this process are meeting all the thresholds and are with customers with paying capacities.

Order wins such as UIDAI managed services programme or the Rs. 600 crores worth of orders won in the previous quarter, have cleared all these thresholds/filters. And hence now we are confident that most of the Rs. 4000 crores of orders in backlog are with customers with paying capacity and with margin after considering potential contingency such as cost escalation or FX variation.

So, to answer your question, we have very good visibility of revenue and assured margin on SI business. This Rs. 4000 crores would translate on an average to about Rs. 1000 crores over the next four years. It's a typically three to five year revenue recognition cycle on our existing orders/bids..

On pure hardware order like ELCOT, because of a sharp rupee depreciation, we had the swing of almost Rs. 32 crores from the time the bid was put and the time it was executed. The Rs./USD rate was in the late 40s when the bid was put. When the project was executed, it was around Rs 55 a dollar. The swing meant a significant loss for a hardware order which had over 90% import content.

Two things are being done now. Entire industry has worked with the customer to introduce fair clauses like exchange rate variation clause. Manufacturing Association of IT has worked with various government procurement agencies to get exchange rate variation clauses accepted.. This in a way mitigates part of the risk.

And second is we have moved internally to a method of forward costing dollar for the full period of booking to collecting money.

Govind Agarwal: Thank you. There is a loss at a net level. Over how many quarters we should be in profit and what should be the operating margins, EBIT margins for the company?

Management: We don't give any forward-looking guidance. Movement from loss before provisions from minus Rs. 31 crores in Q2 has moved to plus Rs. 4 crores, despite having had Rs. 37 crores interest cost for the quarter. On an operating performance level, most of the businesses have turned around. How ever, costs and provisions related to some old projects and their receivables have continued to impact negatively and it may take few more quarters to be out of the system

Net of these cost, there is an operational turnaround..

Govind Agarwal: And my last question would be - what is the amount of receivable, which is under arbitration right now? And is this amount mostly from discoms, public sector companies?

Management: Total receivables in SI Projects is about Rs. 1,000 odd crores, out of which under arbitration or various contract disputes or discussions is about a couple of hundred crores..

Govind Agarwal: Thank you. Thanks a lot and all the very best.

Management: Thank you.

Moderator: There are no further questions on the audio part.

Management: Thank you everyone for joining the call. If you have any additional questions, feel free to write to our investor relations cell and we will also put a transcript of this call as well as these slides on our website for you to refer to them later. Thank you and we will again talk to you next quarter.