Q2 FY14 HCL Infosystems Quarterly Investors Conference Call

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SPEAKERS: **Harsh Chitale, MD & CEO, HCL Infosystems Ltd.**
Sandeep Kanwar, CFO, HCL Infosystems Ltd.

Moderator: Very good afternoon everyone. Welcome to HCL Infosystems quarterly investor conference call. I would like to hand over the proceedings to Mr. Harsh Chitale, MD &CEO, HCL Infosystems Ltd.

Harsh Chitale: Good afternoon everyone. We have our CFO, Mr. Sandeep Kanwar with us on the call. We will talk about our last quarter performance and walk you through our key updates for each of our businesses.

We would like to begin with a mandatory disclaimer. This call may contain forward-looking information including statements concerning our outlook for the future as well as some of our other statements of belief, future plans and strategies. These forward-looking statements and information are subject to risks and uncertainties that they entail.

The transformation continues with the new scheme of arrangement. The businesses has been identified into growth focus areas for future and de-focus businesses to be wind down over period of time.

Key highlights for OND'13, FY14 are:

While Distribution and Services isa near term growth business, HCL Learning is a longer-term bet.
Telecom distribution, a major part of Distribution business, reported a 7% Q-o-Q drop in revenues,after posting a double digit Q-o-Q growth in previous two quarters consecutively.

Non-Telecom distribution business expanded the portfolio by signing new brands. This business has witnessed a 60% year-on-year growth over FY13.

Services business grew 14% Y-o-Y in OND'13. Business has two arms, firstly the Break-Fix Services for enterprises, comprising of Lifecycle Services (LCS) and Office Automation (OA) Services. Similarly for consumers' break-fix services are sold under the brand name CARE. The second type of services are theEnterprise Services namely, Infrastructure Managed Services and Enterprise Application Services. Both type of services, grew14% year-on-year during the quarter.

Learning business is still at a nascent stage and saw revenue decline on a year-on-year basis. There is drop in customer spending in school's category in this Industry. Due to cases of payment defaults in Tier II and Tier III level schools, HCL is focused on engaging with premium schools such as Delhi Public School, RK Puram, Delhi Public School, Mathura Road etc.

The gradual wind down of the non profitable businesses like Computing and hardware solutions business remains a business challenge for HCL.

HCL has been focussing on SI Business with significant services portion and partner backed hardware support, thus de-riskingfrom exposure to exchange rate fluctuations, etc. Besides Systems Integration, HCL has been following a selective approach for pursuing opportunities in Infrastructure Solutions business. Focus has been on projects with no/minimum exposure to foreign exchange and working capital.

Together with these two transitions, HCL is aligning the hardware products business to a distribution and services-oriented sales model in product categories such as PCs, Laptops, Thin Clients and Tablets. Thus, moving from an FX and working capital intensive business to a traded service-oriented business.

Hardware solutions business has undergone three different types of transitions. Firstly, moving to SI services; secondly, moving to very selective projects. And thirdly, moving away frommanufacturing and branding to distribution and services.

Hardware Solutions business would continue to drag overall performance of HCL. Old projects would have to be completed; their milestones need to be signed off; money has to be collected and bank guarantees have to be recovered.

Collections in all government projects continue to remain sluggish, consequently there has been significant provisions for bad debts on these projects in last four quarters. There has been no adverse impact on account of bad debt-related provisions. However, there would be an interest burden due to loans for these projects. The loans would be repaid on completion of the projects and subsequent collection from customers. This would continue for next 12 to 18 months.

HCL aims to close/complete these projects and recover the money and subsequently wind down the interest burden.

Hardware products business took some repositioning charges for winding down of SG&A and liquidation of Inventory. These charges would impact next quarter and would taper off by AMJ'14 quarter. While the hardware business, affected by commoditization and foreign exchange impacts, is expected to be wound down by June 2014, other SI projects with long lead-time would take around 12-18 months.

Post restructuring, HCL computing products is being transitioned into our Distribution business. In our Services business, the Singapore subsidiary of HCL Services is getting very good traction and wins.

Telecom distribution saw a 7% Q-o-Q decline in revenue after two consecutive quarters of sequential growth. The business expanded its last mile footprint and added additional 137 regional distributors till the last retailer in a rural outlet. Overall, the business has over 450 rural distributors which cater to 80,000 retail outlets in the telecom ecosystem. Another addition of over 150 distributors is expected before end of June'14.

The non-Telecom distribution business saw 60% year-on-year growth. The significant y-o-y jump was due to addition of many new clients like Cannon for printers, Yoga Tablets by Lenovo, Huawei for video conferencing and Datacard for ID card printing.

The consumer electronics verticals are taking shape and recording growth.The consumer appliances business added Hamilton Beach, Braun, De'Longhi on top of Harman Kardon and JBL to the distribution portfolio.

Distribution business recorded a consolidated revenue of Rs. 1425 Cr with an operating income PBIT of about Rs. 24 crores. There is very little capital employed or working capital in this business, thus no interest expense. About 100% of Rs. 24 crores goes to our bottom line.

The Consumer Computing and Mobility business is being transitioned into a distribution business, with a focus to move the manufactured branded products to traded distributed products. HCL is focussing on liquidating the inventory and liquidating bills receivable associated with that product lines.

During the quarter, after the transition have been started from one business type to another, the gross working capital has reduced from Rs. 500 crores to Rs. 400 crores. This is expected to be liquidated by June 2014.

This business reported revenue of Rs. 120-crore withoperating loss of Rs. 28 crores, a significant part of which was due to wind down and repositioning charges. The next 2 quarters would have some charges and loss in this segment. This would gradually reduce from a current level and progressively go down further to AMJ'14 by which we hope to wind it down completely.

Services, our second growth pillar, has shown robust traction. The enterprise services grew year-on-year from Rs. 135 crores to Rs. 148 crores, a 14% growth year-on-year and a 6% growth quarter-on-quarter. Consumer Care business, a relatively newer service business, grew from Rs. 10 crores a year ago to 17-crore business in current quarter. A quarter back, it was Rs. 12 crores.The significant ramp up in CARE business is majorly driven by number of new sign ups.

Enterprise service signed Delta and Xerox as two significant large partners for providing national wide break-fix service.

Infrastructure managed services, had a large engagement underway in Singapore with an annual value of approx. $13 million.This high margin $13 million a year engagement for number of government agencies for Singapore government through IDA, the nodal agency in Singapore. HCL, is one of the three companies which has been shortlisted for expansion of that engagement. There is further potential to double or triple this $13 million a year engagement as a result of this short listing. The additional orders in the scope expansion will translate into revenue from 1st of April 2014. There will be a significant ramp up in the infrastructure managed services business going forward.

The Care business witnessed a growth of 40% quarter-on-quarter and close to a 70% year-on-year growth driven by expansion in Care network. Business has already expanded the touch centres to 250 locations and hopes to cross 400 by June 2014.

During the quarter, HCL Care renewed the Nokia repair factory contract with 50% additional scope. Thus, there is a renewal plus additional scope. Care Services for Samsung white goods and Bajaj Electricalswere also started.

Services recorded revenue of Rs. 165 crores with income of Rs. Rs. 15.7 crores for the quarter. Both services and distribution have low capital employed and hence most, if not all, of this operating income flow is also as the ultimate profit.

HCL Learning ran into rough weather with drop in customer spends. Being a very cyclical business, 75% of revenue in Learning business gets done in April-June period,when schools ready themselves for next academic year depending on which part of the country they are in.

The business continued to have the lowest NPAs in the entire industry and due to very good customer selection process, a good track record of collection continues.

It is a business where HCL will not only sell to schools, but the ultimate objective is to drive superior educational outcomes for students and hence presence in schools is just a way of reaching out to students.

With presence in close to 3500 schools today, HCL touches over 70 lakhs students. HCL aims at launching more offerings for these 70 lakhs students. "My IIT Tutor" and "My EduWorld Drive" have been introduced as two such offerings last quarter. Both of these are online as well as offline packages that student can work on at home and improve the educational outcome.

The pilot was initiated with 60 schools. A good traction of 2000 students was reached with in last quarter. HCL is ramping up the offerings to 3500 schools and further.

In this quarter, learning business had a revenue of Rs. 11 crores with an operating loss of Rs.1.4 crores.

Enterprise solutions business, is undergoing the biggest change in the company. The company wants to adopt services-centric system integration business model. The transition, will incur interest cost till all the collection comes and all the money is recovered.Assets have been deployed and project needs to be completed to recover the amounts. There is no easy way out this business model and, hence this transformation would take over the next 12 to 18 months.

HCL is building the asset of SI services. Some good orders have been booked as per that new business model in the last quarter. UIDAI programme are poster child programme in this business. This is one project in our project portfolio and not seeing any challenges in milestone completions or money coming on time and hence that is progressing very well. Already 56-crore Aadhar has been generated. Over Rs. 3500 crores of financial transactions have happened using Aadhar that are generated through our UIDAI service. Number of banks is now using e-KYC service that have been built on our Aadhar platform. So this is taking good shape, notwithstanding all the politics and news around the politics that we hear about UIDAI in the press.

Work is progressing at a very fast pace and there are no payment challenges faced by the company.

There is a consolidated revenue of Rs. 278 crores at a negative EBIT level of Rs. 12 crores for the quarter. Operational profit is eroded by Foreign exchange impact.The company is incurring the nterest expense on account of this business.

Putting all of these together in a dashboard, distribution and services of Rs. 1425 crores and Rs. 165 crores are generating healthy operating profit. Both of them have very little finance cost. These two businesses are growth focus areasand have a very high return on investments and are pillars for the future.

Learning is a small business which is being incubated for the long run. In the calendar year 2013, the business made money. It's an extremely cyclical business and hence in the quarter it has suffered a loss.

The hardware solutions business has an operating loss and its being wound down the products part rapidly and moving out of projects over 12 or 18 months and collecting the receivables.

Consolidated revenue from all the businesses came to Rs. 1982 crores with operating profit of Rs. 0.3 crores. Profit before tax, was a loss of Rs. 40.8 crores on account of Rs. 41.1 crores of interest expenses.

Going forward, solutions – Consumer Computing and Mobility would be wound down, resulting in a decline in the top line and losses in these particular businesses.

Moderator: Let us start the Q&A interactive session. I request all the attendees, if you wish to ask any questions, please press "0" and "1" on your telephone keypad and wait for your name to be announced.

Shri Walson: How large would Nokia be within the telecom piece in the distribution business?

Harsh Chitale: Telecom business has three categories for us. One is Nokia phones. Second is, certain different brands of Tablets. And third is various phone accessories, like, battery, cover, etc. Nokia phone's piece in telecom distribution makes up almost 85 to 90% in a quarter.

Shri Walson: What is the business model for non-telecom business that you are ramping up? Would most of it be predominantly just distribution services or would you be taking inventory risk on management similar to what we are doing in the telecom piece?

Harsh Chitale: In the non-telecom distribution, the business model is identical to telecom. The company buys from the vendor or the principal, which could be Dell, Lenovo, HPs and all these other principals mentioned earlierand sell to downstream resellers and manage the entire capital cycle within the credit that we receive from the vendor or the principal. We technically have an inventory risk in telecom and non-telecom distribution businesses.HCLhas not seen an adverse impact of that risk in the last four-five years.

Shri Walson: Okay.

Harsh Chitale: As it is an extremely short cycle business, the credits offered to the downstream resellers are very, very narrow.

Shri Walson: The enterprise solutions business, has impactedthe overall business performance, possibly, you could see most of the hardware business completely reduced to zero and, possibly, most of the low margin or other low profitable business will be going down to as low as possible?

Harsh Chitale: That is the intent. So two parts in that hardware solutions. The PC Mobility part,that we want to do it even sooner and that's why we are liquidating the entire inventory and receivables' portfolio, the gross working capital. We expect to drive that action over the next six months and complete that so that one part of that bid goes away by mid of this calendar year.
Second part,the enterprise solutions, these are the long-live projects and those are the 12 to 18 months to extinguish the long-live projects and recover all the money. So you will see this solutions' line declining till we bring it and eliminate all and bring it to a level very soon the services' portion of that that is remaining and all the bid has gone away.

Shri Walson: Sir, if you can give us a sense of capital employed in each of these businesses on how do you see that getting moved around across businesses over a 12 to 18 months horizon?

Harsh Chitale: In terms of capital employed, a bulk of the capital has been employed in hardware solutions business. So, winding down of hardware solutions businesswould release a significant capital employed. Hardware Solutions business hasloan book of Rs. 1050 crores and interest-bearing LCs.Winding these down and recovering working capital deployed in projects, would be applied to repay the loans and interest-bearing LCs, which will eliminate the finance costs.

Distribution and services don't need that kind of capital deployment.

Shri Walson: Okay. On the distribution business, what do you think is the kind of steady state margins you can look at because if I compare it some of a couple of your peers, the margins are relatively lower at this point of time. Do you think would revenue growth be the key driver for it to go to slightly higher, maybe, operating margins for 3-4% kind of an operating margins or do you think there is lot of scope for cost take-out also in that space which could possibly happen in the next 12 months?

Harsh Chitale: Ideally distribution business has to be seen together with services because break-fix service, for example, is one of the value-added offering that given to the principal. For example, HCL not only distributes Lenovo Yoga Tablets, but also is a National Service Provider, for those Tablets.Hence, any such relationships not only brings distribution revenue and margins but also brings aftermarket service revenue and margins.

That's why when you look at some of our peers, their numbers are inclusive of both of these numbers.

Now, just the product part, which is the distribution part of the margin, will normally not exceed 2% of operating profit because those are the kind of product-related margins. And then there is certain minimum fixed cost of operations. It's the service margins, which can have an operating profit of over 10%. So margin expansion in just the distribution part will always have a limited scope because our margins from the vendors and principals normally vary from 3% to 10%, but average is, say, close to 4%, translating into finally a off-profit margin of 2%.

Shri Walson: Okay. Sure. Thank you.

Harsh Chitale: Thanks

Moderator: We have a next question from Ankit Pandey from Quant Capital. Your line is opened. You can go ahead and ask your questions. Thank you.

Ankit Pandey: Hi. Good afternoon. My question is pertaining to the infrastructure win that you had announced the 13 million USD ACV. So it has already begun and will that sort of or will that add on to the current 15 to 20% year-on-year growth that we are seeing in this segment?

Harsh Chitale: Yes. $13 million ACV is already part of our 165 crores revenue. The new win will expand $13 million to manifold high-ends will start from 1st of April. That is not part of this Rs. 165 crores and hence should add significantly to this quarter-on-quarter growth that we've reported in services so far.

Ankit Pandey: Okay. I got that. And can you just give me a rough break up of the services business into IMS and enterprise application services?

Harsh Chitale: Our break-fix service portion of the business isRs. 165 crores and enterprise break-fix within this Rs. 148 is Rs. 66 crores. Then, balance is made up of two kinds of managed services. One is a managed service around Office Automation and Printing and second is the Infrastructure Managed Services. There is a 50-50 split between the break-fix services and the managed services in this Rs. 148 crores. And all of the Rs. 17 crores of Care is all of that is break-fix services.

Ankit Pandey: Rs. 17 crores. And can you just give me the number also for the overseas revenue mix if you have the overall one or one inside the hardware?

Harsh Chitale: Yeah. So in the services, overseas revenue right now is $3.5 million. Right?

Ankit Pandey: 3.5?

Harsh Chitale: $3.5 million. So It's about 20 crores of services.

Moderator: Mr. Pandey, your line is unmuted. You can continue with your question.

Ankit Pandey: Yeah. I just had one overseas revenue mix. I think you gave me one in the services. So if there is also a component in the hardware part?

Harsh Chitale: Yes. So hardware solutions business has $6.5 million through HCL Middle East in the solutions space.

Ankit Pandey: Correct. And can you also give me the break out of the enterprise solutions into enterprise hardware and SI?

Harsh Chitale: Yes. So SI is 167 crores.

Ankit Pandey: Okay. That is okay. But I don't get the other one.

Harsh Chitale: Sorry. SI is 111 crores and enterprise hardware is 167 crores.

Ankit Pandey: Okay. Okay. And can you just give me the loss again in the hardware products and SI business? I just miss that.

Harsh Chitale: So on the enterprise solutions, operating loss of 12 crores. And on products, operating loss of R. 27.9 crores.

Ankit Pandey: Okay. And inside the CSMB part, can you just give the break up of CSMB Computing and Mobility also, please?

Harsh Chitale: Yes. So CSMB Computing 76 crores and Mobility 46 crores.

Ankit Pandey: Okay. Thank you so much. I will come back in the queue.

Moderator: Thank you so much, Mr. Pandey. We have the next question from Mr. Abhishek Shah from Corporate Database. Your line is opened. You can go ahead and ask your questions. Thank you.

Abhishek Shah: Sir, you mentioned that it will take about 12 to 18 months for a few long-term projects to end. I am just trying to catch what exactly the order book size of these projects?

Harsh Chitale: Yeah. So the order book size right now stands at about Rs. 2500 crores, of which there are two parts.
First is the Project Phase and the other is O&M Phase. O&M Phase is don't have much challenges. It's like any other services out of the business and that will continue thereafter for three to four years. The phase where there is a capital intensity is the upfront Project Phase and that is what I mentioned 12 to 18 months. One project that will continue for a long time thereafter is UIDAI; however, that is a project where we do not have the challenges that I mentioned.

Abhishek Shah: **Y**ou said there will be some major repositioning charges that you will be taking in the next few quarters. Again, just wanted to know the size of these charges.

Harsh Chitale: We tooka major repositioning charge on the product side in OND, as we wound down one plant out of our two plants. And for the residual portion of the work, shifted all the work only to our Uttarakhand plant from Pondicherry and significantly repositioned with respect to our team. So that significant portion is done in OND. Similarly, a lower magnitude in JFM and thereafter AMJ will be very, very nominal.

Abhishek Shah: Sir, in an approximate number, how much will it be?

Harsh Chitale: I don't have the approximate number it ready with me.

Moderator: Thank you so much, Mr. Shah. Sir, there are no more questions in the queue, so I wouldrequest you to make the final remarks.

Harsh Chitale: Thank you for joining us. Just to summarize, the restructured multi-entity operation will give more visibility into each and every part of our business. The hardware product and hardware solutions businesses are challenged, but we have a defined timelines by which we want to transition them out into assets like distribution and services. Both of these growth pillars are seeing good traction, good growth and profitability. I look forward to having a similar conversation with you a quarter from now. Thank you.

Moderator: Thank you all. We conclude the conference call for today. Have a great evening ahead.