

HCL Technology

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Market Performer

Rs167 P/E (FY03E) - 14x

Revenue ramp-up better than expected, Profits/Margins disappoint

- Revenues for Q2FY03 (Year ending June) were Rs4680mn compared to our estimate of Rs4,555mn.
 - Majority of the incremental revenues have come from offshore engagements.
 - After two bad quarters, Networking vertical related revenues grew 22% sequentially in the quarter under review. Technology Development Services and application related revenues continued to be at Q1 FY03 levels.
 - Europe continued to show strong growth, up some 21% sequentially.
 - DSL Software has grown QoQ at 18 to 20% in Q1 and Q2FY03 respectively; its current contribution to HCL Tech's consolidated revenues is 9%. Going forward, HCL Tech expects this JV to grow faster than the Industry average.
 - HCL Jones' revenues ramped-up by 13% QoQ.
- Net Profits stood at Rs806mn as against our estimate of Rs865mn.
 - HCL Perot Systems, a 50:50 joint venture between HCL Tech and the US-based Perot Systems Corporation accounted for extraordinary provision of Rs111.9mn towards stock-based compensation charges, goodwill impairment and additional tax provisions. Accordingly, the share of income of equity investee of HCL Tech is lower by Rs56mn, (50% of Rs111.9mn extraordinary provision). If effects of this provision are not considered, HCL Tech's Net Profits works out to around Rs862mn.
 - HCL accounted for a deferred tax asset of Rs33.6mn this quarter. This has lowered its effective tax rate from 14.7% in Q1 FY03 to around 8.3% in Q2 FY03.
 - Apart from the above, the following contributed to lower margins ...
 - Lower Utilisation (in H1 FY03, HCL added 850 employees in the Software Services segment)
 - Lower Billing Rates (Offshore rates slid 1% sequentially)
 - Effects of the extended holiday and taxation finalisation related work stoppages from the clients-end.

Client Rationalisation continues; Debtors days reduce

- The client rationalisation exercise continues. This quarter the company 'rationalised' around 14 clients as compared to 33 in Q1 FY03. The company expects the exercise to get over by end of Q3 FY03.
- Debtors Days have reduced significantly, from Q1 FY03 levels of around 86 days to around 73 days in Q2.

HCL Perot – issues resolved

- HCL Tech said that all major outstanding issues in the HCL Tech and Perot Systems JV - HCL Perot have been resolved.
- They also mentioned that Vineet Nayar, CEO, HCL Perot would be concentrating on HCL Perot full time. He would renounce his current responsibilities in HCL Tech and would step down from the Board of HCL Technologies.

BPO Segment

- HCL E-Serve added 220 employees, taking to total up to 494. HCL E-Serve is acquiring new clients and some pilots are underway.
- HCL NI continues to get incremental business from its main client British Telcom, besides which it has acquired a few new clients, which are currently being serviced from Europe.

Unrealised gains from Treasury Investments at Rs564mn

- HCL Tech has around \$284mn (Rs13,632mn) cash and equivalents of which around \$259mn (Rs12,432mn) are in marketable securities i.e. around Rs43 per share.
- Unrealised gains on Marketable securities (treasury investments) stood at around \$11.75mn (Rs564mn), i.e. around Rs2 per share. HCL Tech however, did not confirm when it would be selling the instruments and booking gains.

View and Valuation

The stock is down by around 5% from our call of Market Performer on 22 October 2002. We feel concerns regarding HCL Perot and the Client Rationalization exercise have been bearing down on the stock. Taking Q2 FY03 results into account we have revised out FY03 projections marginally downwards.

Going forward however, our outlook on the stock remains positive. HCL Perot issues stand resolved and the Client Rationalization exercise is also coming to an end in Q3 FY03. Moreover, the DSL JV and HCL Jones apparel JV are expected to register good growth. **We maintain our Market Performer call on the stock.**

Projections

Yearly Projections

Year Ended June 30	Rs Mn		
	2002	2003	Change
		Karvy Estimates	%
Revenue Less: Sales Incentives	16,065	15,995	-0.4%
Net Income	4,796	3,324	-30.7%
No. of Shares	287.9	287.9	0.0%
EPS (Rs)	16.66	11.55	-30.7%
Re. / \$ rate	48.25	48.04	-0.4%
P/E x	10	14	

Note: US GAAP Consolidated Results

Quarterly Projections

Year Ended June 30	Rs Mn		
	Q3 2003	Q3 2003	Q3 2003
	Karvy Estimates	QoQ Growth %	YoY Growth %
Revenues	4,867	4%	20%
Net Profits	845	5%	-35%
EPS (Rs)	2.93	5%	-35%

Note: US GAAP Consolidated Results

US GAAP Results

Year Ended June 30	Rs Mn				
	Q2 FY03	Q1 FY03	QoQ %Chg	Q2 FY02	YoY %Chg
Revenue Less: Sales Incentives	4,680	4,422	5.8%	3,988	17.4%
Cost of Revenues	2,841	2,614	8.7%	2,327	22.1%
Gross Profits	1,839	1,809	1.7%	1,660	10.8%
SG&A	1,023	1,001	2.2%	568	33.9%
Operating Profits	816	808	1.1%	897	-9.0%
Other Income	89	67	32.6%	314	-71.6%
Profit Before Tax	905	875	3.5%	1,211	-25.2%
Tax	75	129	-41.7%	38	95.6%
Profit After Tax	830	746	11.3%	1,172	-29.2%
Share of income from Equity Investees	37	64	-41.7%	89	-58.1%
Minority Interest	61	49	24.0%	29	114.9%
Total PAT	806	760	6.0%	1,232	-34.6%
No. of Shares (Mn)	288	288	0.0%	285	0.9%
EPS (Rs)	2.80	2.64	6.0%	4.32	-35.2%
Gross Margin	39.3%	40.9%		41.6%	
Operating Profit Margin	17.4%	18.3%		22.5%	
PBT Margins	19.3%	19.8%		30.4%	
Net Profit Margins	17.2%	17.2%		30.9%	
Other Income/PBT	9.8%	7.7%		25.9%	
Tax/PBT	8.3%	14.7%		3.2%	

Software Services Segment

Rs Mn

Year ended June 30	Q2 2003	Q1 2003	QoQ %Chg
Gross Revenues	3,905	3,795	3%
Direct Costs	2,116	1,979	7%
Gross Profits	1,789	1,816	-1%
SG & A	817	803	2%
EBIDTA	972	1,012	-4%
Depreciation & Amortisation	145	136	7%
Operating Profits	827	877	-6%
Foreign Exchange Gains/(Loss)	(20)	(20)	0%
Interest & Other Income, net	97	88	10%
Profit Before Taxes	903	944	-4%
Provision for Tax	75	139	-46%
Profit After Taxes	828	805	3%
GPM	45.8%	47.8%	
OPM	21.2%	23.1%	
NPM	21.2%	21.2%	
Tax/PBT	10.7%	9.3%	
Other Income / PBT	8.3%	14.8%	

Note : Q1 FY03 numbers for Software Services Segment were restated in Q3. Software Segment and Government Practice (acquired in June'02) were shown separately.

Government Practice Segment

Rs Mn

Year ended June 30	Q2 2003	Q1 2003	QoQ %Chg
Gross Revenues	113	115	-2%
Direct Costs	86	91	-6%
Gross Profits	28	24	15%
SG & A	41	34	20%
EBIDTA	(14)	(10)	32%
Depreciation & Amortisation	10	10	5%
Operating Profits	(24)	(20)	19%
Foreign Exchange Gains/(Loss)	0	0	-50%
Interest & Other Income, net	0	0	-50%
Profit Before Taxes	(23)	(19)	21%
Provision for Tax	(10)	(5)	83%
Profit After Taxes	(14)	(14)	-2%
GPM	24.3%	20.7%	
OPM	-20.9%	-17.2%	
NPM	-12.3%	-12.3%	
Tax/PBT	-0.4%	-1.0%	
Other Income / PBT	40.6%	26.8%	

IT Enabled Services Segment

Rs Mn

Year ended June 30	Q2 2003	Q1 2003	QoQ %Chg
Gross Revenues	294	222	32.7%
Direct Costs	190	155	22.5%
Gross Profits	104	66	56.6%
SG & A	89	85	5.2%
EBIDTA	14	(19)	-177.0%
Depreciation & Amortisation	40	36	11.0%
Operating Profits	(26)	(55)	-53.0%
Foreign Exchange Gains/(Loss)	9	6	34.4%
Interest & Other Income, net	(2)	(7)	-65.2%
Profit Before Taxes	(20)	(55)	-64.6%
Provision for Tax	5	(6)	-182.1%
Profit After Taxes	(24)	(50)	-51.4%
GPM	35.3%	29.9%	
OPM	-8.8%	-24.8%	
NPM	-8.2%	-22.5%	
Tax/PBT	12.2%	12.5%	
Other Income / PBT	-23.5%	10.1%	

Networking Segment

Rs Mn

Year ended June 30	Q2 2003	Q1 2003	QoQ %Chg
Gross Revenues	391	312	25.4%
Direct Costs	254	202	26.0%
Gross Profits	137	110	24.3%
SG & A	75	79	-4.6%
EBIDTA	62	31	97.1%
Depreciation & Amortisation	23	23	0.0%
Operating Profits	38	8	388.5%
Foreign Exchange Gains/(Loss)	1	0	
Interest & Other Income, net	5	(0)	
Profit Before Taxes	45	8	470.5%
Provision for Tax	5	-	
Profit After Taxes	39	8	403.8%
GPM	35.0%	35.3%	
OPM	9.8%	2.5%	
NPM	10.1%	2.5%	
Tax/PBT	11.5%	-1.3%	
Other Income / PBT	11.7%	0.0%	



24 January 2003
Result Analysis

Stock Ratings Absolute Returns

Buy : > 25%
Out Performer : 16 - 25%
Market Performer : 0 - 15%
Under Performer : < 0%

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