# "Q2 FY13 Results Conference Call of HCL Infosystems Limited"

## February 15th, 2013

**SPEAKER: Management**

**Management:** Good afternoon, we are about to start our web cast now. In the next one hour or so, what I would attempt to do is to give you some colour to our financial results for the quarter of October, November, December and explain where did the growth come from and which were the areas that were impacted that finally led to a loss of Rs. 38 crores on a consolidated basis that was declared. If you look at the broad picture, we actually should register a 6% sequential growth from Rs. 2,456 crores to Rs. 2,606 crores for a consolidated HCL Infosystems as a whole. Despite 6% sequential growth, at the consolidated level, we declared a loss of Rs. 38 crores and I want to dig deeper into that to explain to you where has the loss come from, and what's our view about the businesses going forward.

If we look at the broad business highlights and lowlights, what we saw was our telecom distribution business had a decline of 17% and that's a large part of our business and a decline of 17% in that business almost meant a decline of Rs. 250 crore quarter-on-quarter. If you take that one business aside, all the other businesses put together registered a very healthy growth of 44% sequentially quarter-on-quarter. So, sequentially all the businesses other than our telecom distribution business actually had a very healthy growth. And both the parts put together registered 6% growth sequentially. Within that our services and mobility and the new distribution of consumer electronics and IT brands, all the three, which are our growth areas in future, registered a good sequential growth.

We also started revenue recognition and acceptance of milestones in the UIDAI programme and we had over hundred crore of revenue for the quarter getting contributed by UIDAI managed services programme. Despite the loss that we declared at the consolidated level, we actually had a very healthy free cash flow generation and we generated Rs. 102 crores of operating free cash flow as a company as a whole. All of these highlights and good momentum in our growth focus areas had a cloud on the overall performance because of significant pressures that we continue to face in our hardware and solutions business. Our hardware and solutions business fundamentally consists of computing products, office automation products and system integration. Profitability of these businesses was severely impacted on multiple fronts and we will talk more about that going forward. And I did mention about decline in our telecom distribution business.

Let's now go deeper into each one of our lines of businesses. When we look at our distribution business, the top right chart tells you how our revenue has moved from prior year Q2 FY12, which is on the right most part to this year FY13, and you would see there is a Rs. 500 crores drop year-on-year basis in the telecom distribution business where we distribute phones of Nokia. And on a quarter-on-quarter basis, this is a Rs. 250 crores drop. So, this is one part of business that has seen a significant drop in volumes and it has also impacted the profit. For the quarter-on-quarter basis, there was a Rs. 6 crores drop in profit of our telecom distribution business. So, there was a Rs. 6 crores drop quarter-on-quarter, a significant drop in profitability came here.

The other part of our distribution business which is distribution of consumer electronics and IT brands had a healthy growth both year-on-year where Rs. 116 crores a year back became Rs. 145 crores, which is a 27 or 28% year-on-year growth. And a healthy growth also quarter-on-quarter where in prior quarter we had Rs. 130 crores became Rs. 145 crores in the OND quarter. So, our focal strategy of growing multiple brands in our distribution portfolio and reducing dependence on a single telecom brand is actually now bearing fruit. A new logo for which we began distribution and revenue in OND were Dell, Lexmark Printers, JBL which has music systems, Omron medical devices and Delonghi in consumer appliances. These were significant contributors to the growth of digital entertainment revenue.

So, a mix bag here, a significant growth in the telecom distribution but a good revenue build-up in our other brands and increasingly we will see going forward contribution of our digital entertainment revenue to our overall distribution portfolio going up as a percentage of that revenue. Moving to the enterprise business, the solutions, the hardware and system integration part of the business, again you will see on the right hand column which is a Q2 FY-12 that is a quarter year back. We did Rs. 564 crores of revenue in our solutions and system integration business, which had come by a combination of enterprise hardware, which was Rs. 351 crores, office automation hardware Rs. 95 crores and system integration of Rs. 180 crores. You will see this year the revenue went up to Rs. 914 crores in the corresponding quarter. So significant increase in the revenue for our solutions and SI, both on a year-on-year basis and quarter-on-quarter basis, and the significant contribution to that revenue growth came through system integration revenue.

System integration revenue for many quarters now has consistently shown quarter-on-quarter increase. It is now almost 250% of what it was a year back. For system integration business on our top line and revenue basis is definitely showing upswing and the UIDAI programme is contributing to this upswing. UIDAI programme was almost a Rs. 100 crores of this Rs. 267 crores of revenue of system integration in the last quarter. Despite a healthy growth in top line, we continue to have significant challenges in the environment. And that is what is causing significant pressure on profitability of solutions in SI segment of our business.

Government and enterprise CAPEX spends are down. IT spends are down significantly in first six months of this year. And IT hardware industry as a whole has registered de-growth after a long time and that has created margin pressures on the business as all of us now fight for a smaller pie of the market. Project delays continue because of various policy indecisions that we had talked about in the past. Those project delays for us mean cost increase as we have to deploy manpower and equipment on a longer duration, and also increase in interest cost due to additional working capital that works in that business. Also with the delays in projects and recovery of some of the receivable, some of our receivables also reached their impairment date as per our policy on impairment that we follow for our receivables. And hence we had a significant (BR) or receivable impairment that we had to do in the quarter.

So, our profitability of enterprise solutions and SI business, our hardware and system integration business was significantly impacted in the quarter due to receivables impairment to the tune of Rs. 22 crores. Additional burden of interest for the quarter, we had a Rs. 33 crores cost on account of interest and cost escalation on delayed projects. So, despite having a very healthy growth both on quarter-on-quarter and year-on-year basis, bottom line was severely depressed because of these challenges. Going forward what this tells us is we need to be selective in our hardware and SI deals and lean out operations as we ride out this challenging environment that you are going through as an industry on hardware and system integration.

Moving to our services business, while on a year-on-year basis it appears flat, on a quarter-on-quarter basis we registered a 7% growth. And within that if you dig deeper, it's the enterprise services business, which registered a healthy growth with a number of wins in managed services both in India as well as overseas. The managed services piece of our business now has built a healthy backlog with a TCV (Total Contract Value) booking in excess of Rs.300 crores. We started focusing on managed services just about three quarters back and in the last two or three quarters now we have notched our significant wins and over Rs. 300 crore of contract backlog, which will result into revenue going forward. And hence, the service businesses that we have will have an accelerated revenue growth going forward on the back of this contract bank that had now got built up.

We also registered wins with new sign ups for services of Dell and Blackberry in OND. We have been signed up as their national services partner by both of these OEMs. Revenue conversion for both of them would begin in Jan, Feb and March quarter. While we want both of these agreements in the prior quarter, they did not translate into any incremental revenue. Looking at our high growth trajectory that we expect in services, we have made significant sales investments ahead of growth curve. Also we had some spare consumption and spares impairment in this business that impacted the profitability of services business. While services business continues to be in a double digit EBIT for us, the EBIT decline on a quarter-on-quarter basis essentially on account of this sales investment and some of the spare charges that we took in the quarter.

Moving to mobility and consumer computing, our tablet business continues to grow rapidly. On a year-on-year basis, it has now become four-fold from Rs. 14 crores a year back when we started this business, that was the first quarter then, now it has already become four-fold and this is a profitable line of business for us with healthy gross margins as well as healthy EBIT.

On the other hand, consumer computing continues to be sluggish. If we go by the latest IDC report that has come out just a week back, industry has de-grown in consumer computing. And this de-growth has also impacted margins severely and there are pressures on TRAI with this industry de-growth. So, in this segment, our focus is going to be continuously on rapid growth of tablets while having the selective play in consumer and SMB computing.

Moving to the other segment of learning, learning is a very cyclical business and bulk of the business happens in the four months from February to June because that's the period when schools buy just before their new session begins. Rest of the eight months in the year are fairly tepid and we observe the same this year. It was a flat performance year-on-year and fairly flat also quarter-on-quarter. The next two-quarters were where bulk of the action in the learning business happened with its cyclical nature. In the quarter, however, we did get into two new growth areas in learning. First one was, we took the content that we had acquired through our content organisation acquisitions six months back and we took that content to the B2C market straightaway to students and not just visiting it to schools and introduced that content on tablets and various PC dongles.

It is a new introduction done. Such a category does not exist in the market, and we are incubating such a new category as a new growth programme for learning. We also took this content and took it to Middle East and Africa and have already started registering some wins there and we are seeing good traction. Content monetization when it takes on will create a high margin, high EBIT new line of business in learning because here there is very little incremental cost associated with every sale of content. However, it's still a small new incubation that's happening and we are looking forward to it catching on in quarters and years going forward.

If you look at how the numbers stack up across businesses, you will see, we have moved now to a much detailed segment reporting. Those of you who have had a look at our revised segments reporting, we have started reporting our business now in four new segments which are hardware and solution segment, services segment, learning segment and distribution segment. Solution business grew 57% quarter-on-quarter and 51% year-on-year. And within that enterprise hardware which is basically the PCs and the various traded computers, servers and networking products that we sell to enterprises, that registered a 71% growth quarter-on-quarter and 45% growth year-on-year to log in Rs. 646 crores of revenue in our quarter two of FY13. And this growth has come despite decline in the market. I spoke about how the IT spend in the industry has gone down significantly in the first six months of the year. So, despite a declining market, we were able to register a healthy growth. However, that healthy growth has come at the cost of margins and because of significant price pressure with this decline in the market.

System integration business showed 90% growth quarter-on-quarter and 126% growth year-on-year, thanks to a large chunk of this coming UIDAI programme that was signed up six months back. Consumer computing and mobility, part of this segment registered 17% quarter-on-quarter and 20% year-on-year growth. Overseas business, largely we do hardware and solutions business in the Middle East. That is the business which is under pressure for us. And that business, we also had to do certain impairment and cost resetting of about Rs. 7 crores. And that has also depressed profitability. Somewhat later, we will also talk about what was the swing in profit despite this healthy growth in revenue of this business. We will speak about that a little while from now.

Services business, 7% quarter-on-quarter growth; learning business flattish, but the entire learning business action really happened in Jan to June. And hence, a period of action will happen now. Telecom distribution is the business that has dropped significantly both year-on-year and quarter-on-quarter. And the drop in the quarter has been almost Rs. 250 crores; whereas, the digital entertainment business has grown 25% over the last one year. We did have Infinity business historically, which is now a discontinued business. And going forward, we would not have any reporting on this Infinity business as it was divested a year back to Tikona. On the whole, quarter-on-quarter growth was 6%. When we look at our consolidated PBT, we reported a loss on a consolidated basis of Rs. 38 crores at net income level and a PBT level of Rs. 52 crores. And bulk of swing in profit came out of Enterprise Solutions & Services. Rs. 14 crores of that impact came out of receivable impairment. We did a Rs.22 crores impairment of receivables in this business, the Enterprise Solutions Business, which was Rs. 14 crores more than what we had done in the prior quarter. We also had to book a loss on one large old order of laptops from a state government. That order was booked a year back when the exchange rate was at Rs. 49 (to the dollar). We have been working with our various suppliers and the customers to reschedule the deliveries to make it a little more acceptable and bearable because the total impact on account of swing in exchange rate on that order on us was Rs. 32 crores. We were able to mitigate bulk of that impact, but finally when we executed that still meant a loss of Rs. nine crores in that entire order; two crores of that was in the prior quarter and seven crores was in this quarter.

Hence, on a quarter-on-quarter basis, it meant an additional impact was seven crores. For the full order as a whole that impact, however, was significant. It was a Rs. 32 crore impact on account of exchange rate. When we have booked it, it was 49. Average exchange rate as we executed it was 54.5 on an order of Rs. 270 crores, it meant an impact of Rs.32 crores.

Project delays that I spoke about did mean increase in our project cost, both in India as well as the Middle East. And those cost restatement impacted seven crores on a quarter-on-quarter basis on our bottom line. Actually, the investment and some spare charges that we took for the quarter meant seven crore impact on our services. Interest cost increased in the quarter by five crores. Again, bulk of that interest cost is on account of our enterprise solutions business, the system integration business where there is a significant working capital that is still locked up. And that has increased our interest cost both in the quarter.

Telecom distribution dropped which was a drop of close to Rs. 250 crores from prior quarter to this quarter meant a corresponding drop of gross margin which straight flowed to bottom line. And that was the impact of six crores. We did have an additional branding expense, both for corporate branding and product branding in the Diwali period and the December period. And that was the eight crore additional spend that was done in the quarter. So two big swings that happened: One was on account of solutions business where it was the BR Impairment project cost over our exchange rate impact and the additional interest cost impact. All of them put together took that solution segment of ours in a loss despite a very healthy year-on-year and quarter-on-quarter revenue growth. And telecom distribution business which continued to remain profitable, however, had a dropped in its profit, with dropped in the revenue of Rs.250 crores in the quarter. And hence, we had to declare losses of Rs. 38 crore on a consolidated net profit basis despite registering a healthy sequential growth on revenue.

Our focus areas for the remaining part of the year continued to be around what we had around earlier which is growth in our services, both for the consumer services as well as enterprise services, growth in our multi brand distribution in IT as well as consumer electronic. So, that gets done through our distribution subsidiary, Digilife Distribution and Marketing Services. Growth in learning portfolio where we are now taking the content IP that we acquired six months back and monetizing it by taking it to consumers and other geographies. A successful ramp-up of UIDAI programme, it has already begun in December. We recorded a Rs.100 crores revenue but there is a significant revenue now expected in the balance two quarters of the financial year for us.

And we continue to explore strategic partnerships where our businesses are challenged, which is in PC and system integration business. To have more razor sharp focus on these different parts of our businesses which are behaving differently in the market and have different needs, for example, in system integration business and in hardware business, it's all about leaning our operation focusing our working capital and a selective play, whereas, in our learning business, where a lot of incubation is happening and in services business which is growing and where our sales investments are required ahead of the growth curve, we are actually looking at our different businesses in different trajectory.

Hence, we have announced restructuring of the company about a month back and we have already made a public disclosure about this where we are re-organising the company into different subsidiaries. We have already announced a distribution subsidiary a year and half back and that's our Digilife Distribution and Marketing Services. We had announced creation of subsidiary, HCL Computing Products Limited for our PC and mobility business. And for our solutions services and learning businesses, we have announced re-organisation a month back. Fundamentally, this re-organisation, we believe, will allow us to prepare our company to go in a focused manner on these different businesses which have different needs in terms of portfolio, in terms of talent, in terms of investments and immediate priority. This will allow us to give more focused management attention to each of those businesses. Where the businesses are stretched, the focus is going to be on cost optimisation and leaning of operation, where the businesses are on high growth curve, like, mobility or services and multi-brand distribution is going to be all about how do we grow even more rapidly. It's also going to get greater visibility to us as well as to our investors in operational and financial performance of each of these lines of businesses. And we have made a beginning in that with our segment reporting for this quarter. It will also allow opportunities for strategic partnership where necessary. For example, we are seeking such strategic partnership in our PC business and system integration business. And it will also create more flexibility for fund raising, for future growth and expansion where necessary.

So that was the rationale for restructuring. And we continue to have focus on these five different lines of business in a more focused manner. With that I would now throw the lines open for any questions that you may have about the quarter that has gone by or about the restructuring that we announced just a month back. Thank you.

**Moderator:** Thank you very much, sir. Now, I request all the participants to join the "Q&A" using the dial-in details already shared with you. I request all the participants to join the "Q&A" using the dial-in details already shared with you. I request all the participants to join the "Q&A" by using the dial -in details already shared with you.

**Management:** So, since there are no other questions, we would stop the webcast here. As always, this material will also be put on our website. And should you have any queries about what we shared today, please do feel free to get in touch with out Investor Relations. Thank you for joining us today.