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Company Update

HCL Tech

Market Performer
Rs192

HCL Infosystems

Short Term - Outperformer
Long Term – Not Rated
Rs94

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HCL Tech to acquire HCL Infosystems' Software Exports business and Call center

HCL Tech has announced that it proposes to acquire the software exports business and a call center of HCL Infosystems.

Software Exports Business Acquisition

Merger Ratio

HCL Tech would issue 7.09mn fresh equity shares to HCL Infosystems shareholders. This essentially means that for every 9 shares held in HCL Infosystems, shareholders would get 2 shares of HCL Tech (in the ratio of 2:9). HCL Tech would also takeover the latter's 883 employees including 776 technical employees (both Onsite and Offshore) and development centers in Chennai, Kolkata and Noida. At current price levels, the deal is worth around Rs1361mn (\$28mn) for HCL Tech.

Goodwill Treatment

Value of the assets taken over is at around Rs350mn. This would mean that around Rs1000mn would have to be accounted for as Goodwill in HCL Tech's books. As per US GAAP norms, both HCL Tech and HCL Infosystems come under the same promoter group (the promoter group holds around 55 to 65% in both HCL Tech and HCL Infosystems). The acquisition, to the extent of ownership by the promoter group, would be accounted for under pooling of interests and the rest as a purchase. Hence, to the extent it is accounted for under pooling of interest, no Goodwill will be taken on books. The amount of goodwill accounted for may be as little as around 30 to 40% of the Rs1000mn or around Rs300 to Rs400mn because of the above reason.

Financials

The division earned around Rs178mn from revenues of Rs1700mn in FY02. i.e. Net Margins of around 10%. The margins seem to be on the lower side, compared to around 20% expected for HCL Tech in FY03. According to the company, the lower margins are mainly due to lack of sufficient scale. The Software Export Business gets around 50% of its revenues from the Far East where the margins are lower compared to revenues from US or Europe.

Rs20mn revenue in FY02 subcontracted from HCL Tech

HCL Tech subcontracted around 4000 man-months of worth work in FY02. This is equivalent to around 333 technical employees. HCL Tech has mentioned that a major portion of this work is subcontracted Onsite. Around Rs20mn of the work that HCL Infosystems' Software Export Business was doing was being subcontracted from HCL Tech.

Call center Acquisition

HCL Tech would pay a sum not exceeding Rs20mn for the technical help desk Call Center business of one of HCL Infosystems' subsidiaries. HCL Tech would acquire around 168 agents and 128-seats capacity call center. The division must be in the infancy stage last year (FY02), as it clocked only around Rs26.3mn in revenues and Rs0.8mn in profits. According to our initial estimates based on the current capacity of the call center, it may end FY03 with revenues of around Rs180mn.

Post-demerger HCL Infosystems' book value at Rs73 per share!

Even post demerger of the Software Exports Business and Call Center from HCL Infosystems, the company would still have a book value of around Rs73 per share (*refer table*). Other businesses of HCL Infosystems are just about breaking even. Together they show around Rs25mn in losses for FY02. This translates into around Rs0.78 loss per share. An initial look at HCL Infosystems' other business' products, its services profile and its current financials, we feel that the company can maintain or improve its current profitability levels in FY03.

Year ended June 30	HCL Infosystems			
	Software Exports Division	Call Center	Other Businesses	Consolidated
Revenues	1,700	26	11,944	13,671
Profits	178	1	(25)	154
EPS (Rs.)	5.57	0.03	(0.78)	4.82
No. of Shares (Mn)				31.9
Book Value as of now *	350	20	2,328	2,698
<i>Per Share (Rs)</i>	<i>10.97</i>	<i>0.63</i>	<i>72.94</i>	<i>84.54</i>
Book Value Post-Demerger *	-	-	2,328	2,328
<i>Per Share (Rs)</i>	-	-	<i>72.94</i>	<i>72.94</i>

Note: Book Value for Call Center business are Karvy Estimates.

HCL Infosystems' shareholders will get HCL Tech shares in the ratio of 2 shares for every 9 shares held. At the current HCL Tech share price of Rs192, this works out to a value of around Rs43 per share benefit for HCL Infosystems shareholders.

Current HCL Tech Share Price X	2	=	Rs192 x	2	=	Rs43 per share
	9			9		

The Book Value of HCL Infosystems (Rs73 per share) plus the Value of HCL Tech shares to be issued (Rs43 per share), gives us, a value of around Rs115 to 120 per HCL Infosystems share (before the record date of the HCL Tech share issue). Thus, we see atleast an Rs25 upside in HCL Infosystems from its current share price of around Rs94.

View

HCL Tech

We maintain our **Market Performer** rating on the stock. As per our estimates, the acquisition would add just around 12% to the HCL Tech topline in FY03. The valuation of the acquisitions also seems to be fair. Acquisition of Software Exports business does bring some expertise and scale to the company but, it will be marginal compared to the vast pool of expertise and scale of HCL Tech has currently. The increment to the FY03 (E) EPS estimates would be only around Rs0.40 per share (after accounting for equity dilution.)

HCL Infosystems

HCL Infosystems still continues to provide the following products and services in India.

- IT related Hardware and Manufacturing/Assembling and Distribution
- Software product Distribution
- Call center solution and Infrastructure Consultancy
- Infrastructure Services
- Project Management Services
- Hosting Services

- Networking Services
- Migration Services
- Facilities Management

HCL Infosystems has partnerships with some leading global player like Intel, Toshiba, HP, Ericsson, Microsoft, Nokia and Sun Microsystems among others. It also has direct customer services center across 160 locations and two state-of-the-art manufacturing facilities.

While these businesses may not be as profitable as IT services, however, we still see the potential for these business to be turned around in the near future.

We do not maintain an active coverage of this stock, and hence have no Long Term Rating on the stock.

However, as explained above, the recent developments do present an opportunity of making a potential profit of around Rs20 to 25 per share. We rate the stock as Short Term – Out Performer with the target of around Rs120 (before record date of the HCL Tech share issue).

Software Export Business – Short Description

Financial Profile

- Rs1700 mn Revenues for FY02 Growing at around 20%
 - Rs20mn Revenues subcontracted from HCL Tech
- Rs178mn Profit for FY02
- Rs350mn in Total Net Assets
 - Rs48mn (\$1 mn) in Fixed Assets
 - Rs432mn (\$ 9mn) in Debtors
 - Rs240 mn (\$ 5mn) in Cash

Services Provided

- Packaged Implementation Services
 - SAP Practice
 - SCM Practice
- Enterprise Application Integration
- System Integration
- Business Intelligence
- Workflow & Imaging

Top Vertical Segments Serviced

- Transportation
- Govt.
- Corporate
- Banking

Geographical Revenue contribution (as % of Revenues)

- The Far East – 50%
- US and UK – 50%

Client Concentration (as % of Revenues)

- Top 5 client – 29.8%
- Top 10 client – 43.5%

Manpower Details

Onsite	292
Offshore	484
Total Technical Employees	766
Sales	40
Admin	77
Total Employees	883
Utilization rate (as % of Billable manpower)	71%

Call Center – Short Description

Financial Profile

- Rs 26 mn Revenues for FY02
- Rs 0.8 mn Profit for FY02
- Rs 20 mn in Total Consideration to be paid

Services Provided

- Technical Help-desk

Geographical Revenue contribution (as % of Revenues)

- US – 100%

Clients

- A Large US Telecom company
- A US Internet Service Provider (ISP)
- SomeUS Software Product companies

Manpower Details

Total Seats	128
Total Agents	168

Appendix

Merger Ratio details

Year ended June 30 (Rs Mn)	HCL Tech	HCL Info	HCL Tech Post Merger
Equity (Rs. Mn)	574	319	588
No. of Shares (Mn)	287.01	31.91	294.10
Additional Shares Issued (Mn)	7.09		
<i>Ratio</i>	<i>2 Shares</i>	<i>9 Shares</i>	
Share Price (Rs.)	192	94	192
Market Cap (Rs. Mn)	55,106	2,999	56,467
Market Cap (\$ Mn)	1,125	61	1,152

HCL Tech Revenue and Profitability

Year ended June 30 (Rs. mn)	HCL Tech	HCL Info Software Export Business	HCL Info Call Center	Common	HCL Tech Post Merger
FY2002 Results					
In \$ mn					
Revenues	333	36	1	0	369
Net Profits	99	4	0	0	103
<i>Re. / \$</i>	<i>47.74</i>				
Rs Mn					
Revenues	15,890	1,700	26	20	17,596
Net Profits	4,745	178	1	2	4,922
<i>NPM (%)</i>	<i>30%</i>	<i>10%</i>	<i>3%</i>	<i>10%</i>	<i>28%</i>
EPS Rs	16.53				16.73
P/E (FY02) x	12				11
FY2003 E					
In \$ mn					
Revenues	336	35	4	-	375
Net Profits	73	4	0	-	78
<i>Re. / \$</i>	<i>48.00</i>				
Rs Mn					
Revenues	16,137	1,700	180	-	18,017
Net Profits	3,527	178	19	-	3,724
<i>NPM (%)</i>	<i>22%</i>	<i>10%</i>	<i>10%</i>		<i>21%</i>
EPS Rs	12.29				12.66
P/E (FY03E) x	16				15