Arihant Capital
Generating Wealth

Q3FY23 Result update
25th Jan, 2023

HFCL Ltd

Beats on all the margin fronts; slight miss on revenues

CMP: INR 71

Rating: BUY

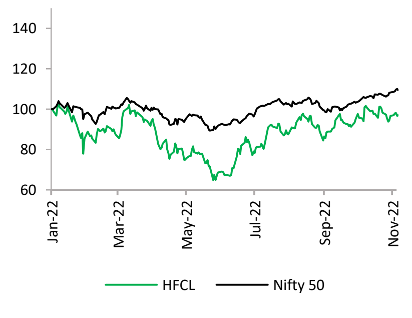
Target Price: INR 128

Stock Info	
BSE	500183
NSE	HFCL
Bloomberg	HFCD:LI
Reuters	HFCL.NS
Sector	Cables
Face Value (INR)	1
Equity Capital (INR cr)	137.5
Mkt Cap (INR cr)	9,762
52w H/L (INR)	88.8 / 52
Avg Yearly Volume (in 000')	9,684

Shareholding Pattern % *(As on Dec, 2022)*	
Promoters	39.24
DII	2.64
FII	6.52
Public & Others	51.61

Stock Performance (%)	**3m**	**6m**	**12m**
HFCL	-6.2	13.4	-12.6
NIFTY	2.2	8.9	5.9

HFCL vs Nifty



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HFCL Ltd reported strong numbers, Q3FY23 revenue stood at INR 1086cr (-10.6% YoY/-7.5% QoQ) vs our estimates of INR 1,104cr. Gross Profit stood at INR 330Cr (+5.8% YoY/-2% QoQ); beats our estimates of INR 306cr. Gross margins improved by 472 bps YoY (up by 171 bps QoQ) to 30.4% vs 25.7% in Q3FY22. The raw material cost in terms of sales stood at 69.6% vs 74.3% in Q3FY22. EBITDA stood at INR 188cr (+10% YoY/+13% QoQ); beats our estimates of INR 168cr. EBITDA margin improved by 324 bps YoY (up by 313 bps QoQ) to 17.3% vs 14.0% in Q3FY22. PAT stood at INR 102cr (+23.5% YoY/+21.9% QoQ); beats our estimates of INR 82cr. PAT margin improved by 259 bps YoY (up by 225 bps QoQ) to 9.4% vs 6.8% in Q3FY22. Telecom Products revenue stood at INR 693cr (+35.2% YoY/+3.2% QoQ), EBIT margin improved by 517 bps YoY (up by 681 bps QoQ) to 19% vs 13.8% in Q3FY22. Telecom Products revenue share increased to 64% vs 42% in Q3FY22. Turnkey Contracts and Services revenue stood at INR 392cr (-44.2% YoY/-22% QoQ), EBIT margin contracted by 82 bps YoY (down by 393 bps QoQ) to 9.7% vs 10.5% in Q3FY22.

Key Highlights

Capacity expansion will drive business growth: HFCL is expanding optical fibre cable (OFC) capacities from 25.08 mn fkm to 35.08 mn fkm over the period of the next 2 to 3 years. As part of its backward integration, HFCL is expanding its optic fibre capacities from 10 mn fkm to 24.94 mn fkm in upcoming years. The Capex is expected around INR 900cr for OF & OFC capacity and setting up new facilities for telecom and networking products and continued R&D over the next 3 to 4 years. The Capex of INR 425cr to development and manufacturing of telecom products including 5G radio equipment, Routers, Switches, Wi-Fi products and Backhaul radios. Out of INR 900cr capex, the company has been granted to avail incentives up to INR 652cr under the PLI scheme over the next 4 to 5 years. The phased capacity expansion will increase competitiveness and helps to reduce operating costs which is expected to result in an increase in margins and profitability.

Focused to increase exports and emerge the largest global player: HFCL is exporting optical fibre cables and telecom components to more than 30 countries and serving more than 80 clients globally. The export revenue stood at ~INR 363cr in FY22. The export revenue crossed more than INR 600cr in 9MFY23 and expected to reach INR 850cr by FY23 and around INR 1,500cr by FY24. HFCL has focused to build global customer relations, strengthen export footprints over the next 3 years, and emerging as the largest global payer.

Focused on product portfolio expansion: HFCL has focused on product expansion, especially margin accretive products lead to an increase in product revenue share from 20% (FY20) to 64% (Q3FY23). The continuous focus on margin-accretive products across segments and the development of new products in telecom and defense electronic products would lead to diversification and de-risk the overall business model. HFCL has also entered into defense electronics such as night vision devices, electronic fuses, radio communication equipment, etc. The change in product mix will improve the working capital cycle going forward.

Innovative products backed by strong R&D: HFCL has R&D centers in Bengaluru and Gurgaon and is heavily invested to develop the products to meet the accelerated rate of fibrerization, 5G product demand, and tap the opportunities in defense and railways. R&D expenditure is expected around INR 150cr in FY23. HFCL has partnerships with Wipro and Capgemini for designing the latest generation telecom products such as 5G, routers, switches, backhaul radios, Wi-Fi access points, etc.

Outlook & Valuation: HFCL has strong R&D for innovative products, focused more than 2x of exports, capacity expansion, product portfolio expansion, and a strong client base such as Jio, Airtel, Tata, etc would drive the business going forward. We have used a DCF Model to value HFCL, it has healthy and consistent cash flow generation over the forecasted period. We have discounted the cash flows using WACC and valued the company at INR 128 per share. We maintain "BUY" rating with Target Price of INR 128 per share; an upside of 79.7%.

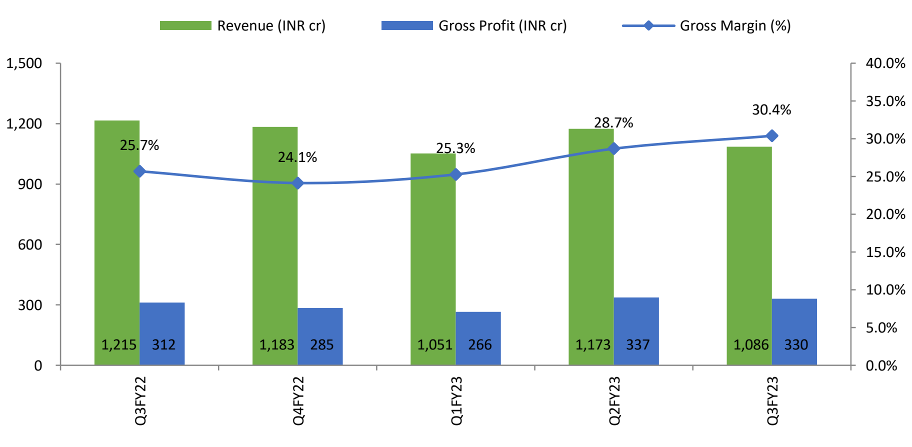
Q3FY23 Results

Income statement summary

Particular (INR cr)	Q3FY22	Q2FY23	Q3FY23	YoY (%)	QoQ (%)
Revenue	1,215	1,173	1,086	-10.6%	-7.5%
Net Raw Materials	903	837	756	-16.3%	-9.7%
Employee Cost	82	90	84	3.1%	-6.0%
Other Expenses	60	81	58	-2.7%	-28.2%
EBITDA	**171**	**166**	**188**	10.0%	13.0%
EBITDA Margin (%)	**14.0%**	**14.1%**	**17.3%**	**+324 bps**	**+313 bps**
Depreciation	20	21	20	2.0%	-5.6%
Interest expense	39	39	37	-5.3%	-6.1%
Other income	4.0	8.6	5.7	42.6%	-33.8%
Profit before tax	**109**	**114**	**137**	25.1%	20.3%
Taxes	28	30	35	24.4%	19.7%
PAT	**81**	**84**	**102**	25.3%	20.5%
Other Comprehensive income	1.1	(1.0)	(0.1)		
Net profit	**82**	**83**	**102**	23.5%	21.9%
Net profit Margin (%)	**6.8%**	**7.1%**	**9.4%**	**+259 bps**	**+225 bps**
EPS (INR)	**0.6**	**0.6**	**0.7**		

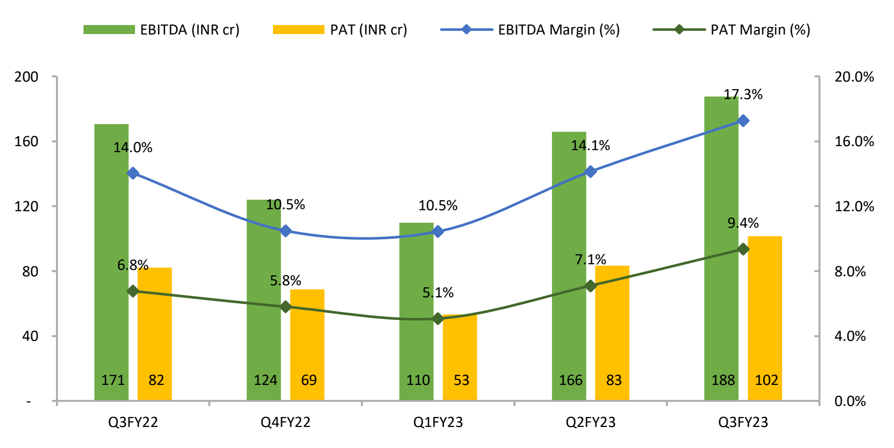
Source: Company Reports, Arihant Capital Research

Exhibit 1: Gross margins improved by 472 bps YoY to 30.4% due to lower RM costs.



Source: Company Reports, Arihant Capital Research

Exhibit 2: EBITDA Margin improved by 324 bps due to reduction in RM costs and other expenses.



Source: Company Reports, Arihant Capital Research

Concall Highlights

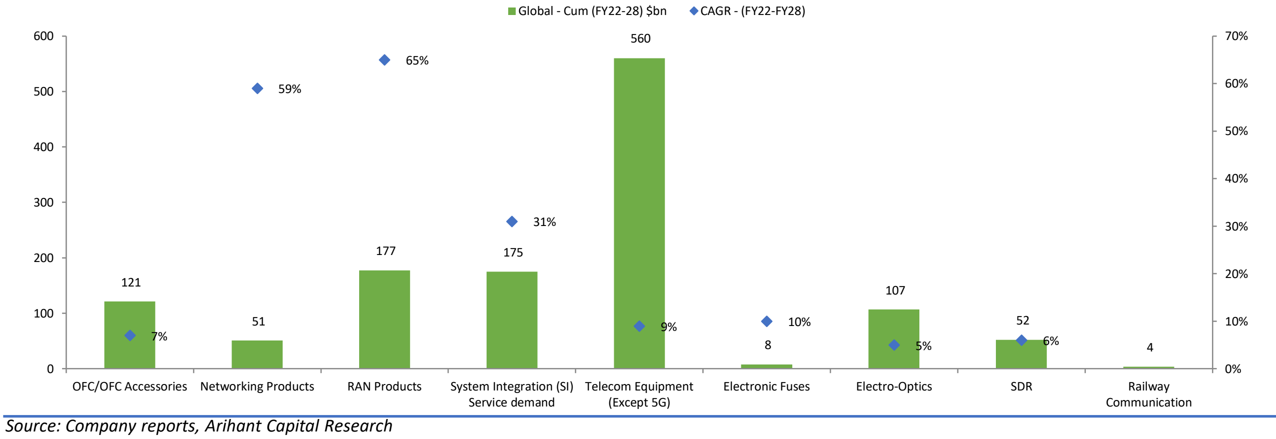
- The order book stood at INR 7,064cr, showing potential revenue visibility. The order book from JIO is more than INR 1,000cr.
- The company will avail incentives up to INR 652.38cr under the PLI scheme over the next 4 to 5 years.
- The Capex of INR 425cr will be for the development and manufacturing of telecom products including 5G radio equipment, routers, switches, Wi-Fi products, and Backhaul radios.
- The company has secured INR 1,770cr worth of EPC contracts, including one for laying fiber optic cables to implement a rural water supply network. The project PBT margin is expected to be around 10%.
- Optic Fiber Capex is estimated at around INR 357cr and capacity is expected to be added in FY25. The Capex is focused on the increase in demand for OF and OFC in India and global markets.
- The company is focused on night vision devices, electro-optical devices, electronic fuses, etc. in the defense electronics segment.
- Electro-optics will be commercialized first and will be followed by other products. There are around 6 to 7 players in the Electro-optics market.
- The average working capital days are around 125. Products working capital days are around 90 and EPC contracts are around 150 days. Telecom product revenue contribution increased from 20% in FY22 to 64% in Q3FY23. This change in the product mix will improve the working capital cycle going forward.
- The company has technology partnerships with 12 technology players. Qualcomm is partnered with HFCL to design and development of 5G Outdoor Small Cell products. Wipro is designing 3 kinds of Routers: 100, 200, and 300 GPPS for HFCL.
- The company is focused on exports. The export revenue crossed INR 600cr in 9MFY23. The management upgraded the export revenue target of around INR 850cr vs INR 750cr earlier. Europe witnessed traction and the company got more orders. The Indian market is around 7% and the remaining 93% is from global markets. The company continues to explore global markets.
- The company is focusing on increasing revenue from the private sector and decreasing revenue from the government sector.
- Optical Fiber cable revenue is expected INR 2,300cr to INR 2,400cr for FY23 vs INR 1,700cr revenue of the previous year.
- The company is focused on new geographies, new customers, and new products. They are shifting toward more margin-accretive products.
- The company is selecting EPC projects which are profitable and cash positive.

Products and Addressable markets

Exhibit 3: Product Offerings

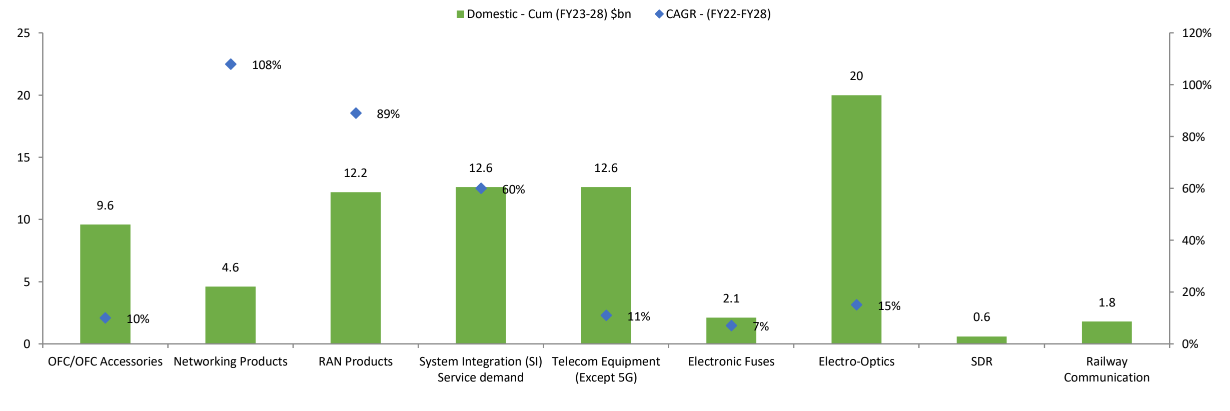
Source: Company reports, Arihant Capital Research

Exhibit 4: 5G segments such as Networking products and RAN products are expected to grow at faster rate over the period of FY22-FY28E. Global markets has more than 90% of addressable market.



Source: Company reports, Arihant Capital Research

Exhibit 5: Domestic addressable market is expected to grow faster than global markets. Networking and RAN products are expected higher growth rate over the period of FY22-FY28E.



Source: Company reports, Arihant Capital Research

Outlook & Valuation

HFCL is expected to benefit from 5G, INR 3lakh cr opportunities in the telecom space, and INR 1 lakh cr opportunities in the defense space. Earlier, the growth was based on telecom capex. Currently, it is based on telecom, defense and railways due to a structural change. HFCL has strong R&D for innovative products, working toward doubling exports, capacity expansion, product portfolio expansion, and a strong client base such as Jio, Airtel, Tata, etc. will drive the business going forward. **We have discounted the cash flows using WACC and valued the company at INR 128 per share. We maintain "BUY" rating with Target Price of INR 128 per share; an upside of 79.7%.**

DCF Valuation

Valuation Assumptions	
g (World Economic Growth)	3%
Rf	7%
Rm	12%
Beta	1.1
CMP	71

Valuation Data	
Total Debt (long term borrowings) (2022)	141
Cash & Cash Equivalents (2022)	528
Number of Diluted Shares (2023)	137
Tax Rate (2023)	27%
Interest Expense Rate (2023)	14%
MV of Equity	9,762
Total Debt	141
Total Capital	**9,902**

WACC	
We	98.6%
Wd	1.4%
Ke	13.0%
Kd	10.2%
WACC	**12.9%**

FCFF & Target Price

FCFF & Target Price	Explicit Forecast Period						Linear Decline Phase				Terminal Yr	
Particular (INR cr)	**2023**	**2024**	**2025**	**2026**	**2027**	**2028**	**2029**	**2030**	**2031**	**2032**	**2033**	**2034**
EBIT * (1-Tax Rate)	452	575	747	985	1,378	1,968	2,680	3,471	4,266	4,960	5,438	5,601
Dep	82	104	106	110	112	117	160	207	254	296	324	334
Purchase of Assets	(485)	(498)	(98)	(119)	(116)	(102)	(139)	(180)	(222)	(258)	(282)	(291)
Changes in Working Capital	506	3	(227)	(224)	(492)	(656)	(894)	(1,158)	(1,423)	(1,655)	(1,814)	(1,868)
FCFF	555	183	529	752	883	1,326	1,806	2,340	2,875	3,343	3,665	
Terminal Value											38,052	
Total Cash Flow	**555**	**183**	**529**	**752**	**883**	**1,326**	**1,806**	**2,340**	**2,875**	**3,343**	**41,717**	

Enterprise Value (INR cr)	17,156
Less: Debt (INR cr)	141
Add: Cash (INR cr)	528
Equity Value (INR cr)	17,544
Equity Value per share (INR)	**128**
% Returns	**79.7%**
Rating	**BUY**

Sensitivity Analysis

WACC (%)	Terminal Growth (%)								
128	2.0%	2.3%	2.5%	2.8%	3.0%	3.3%	3.5%	3.8%	4.0%
11.8%	139	142	145	148	151	155	159	163	167
12.0%	134	137	140	143	146	149	153	156	160
12.3%	130	132	135	138	140	144	**147**	150	154
12.5%	125	128	130	133	135	**138**	141	144	148
12.8%	121	123	126	128	**131**	133	136	139	142
13.0%	117	119	122	**124**	126	129	131	134	137
13.3%	114	116	**118**	120	122	124	127	129	132
13.5%	110	112	114	116	118	120	122	125	127
13.8%	107	109	110	112	114	116	118	121	123

Source: Company reports, Arihant Capital Research

Financial Statements

Income statement summary

Y/e 31 Mar (INR cr)	FY20	FY21	FY22	FY23E	FY24E	FY25E
Revenue	3,839	4,423	4,727	4,865	5,689	6,991
Net Raw Materials	2,934	3,404	3,499	3,563	4,113	5,033
Employee Cost	224	253	311	316	370	454
Other Expenses	186	217	268	284	315	373
EBITDA	**494**	**550**	**650**	**701**	**891**	**1,130**
EBITDA Margin (%)	**12.9%**	**12.4%**	**13.8%**	**14.4%**	**15.7%**	**16.2%**
Depreciation	(42)	(69)	(78)	(82)	(104)	(106)
Interest expense	(115)	(175)	(166)	(162)	(155)	(142)
Other income	22	35	43	58	198	213
Profit before tax	**358**	**337**	**442**	**515**	**830**	**1,094**
Taxes	(121)	(91)	(116)	(139)	(224)	(295)
Net profit	**237**	**246**	**326**	**376**	**606**	**799**
Reported Netprofit Margin (%)	**6.2%**	**5.6%**	**6.9%**	**7.7%**	**10.6%**	**11.4%**
Other Comprehensive income	1	5	2	-	-	-
Net profit	**238**	**251**	**328**	**376**	**606**	**799**
EPS (INR)	1.9	2.0	2.4	2.7	4.4	5.8

Source: Company Reports, Arihant Capital Research

Balance sheet summary

Y/e 31 Mar (INR cr)	FY20	FY21	FY22	FY23E	FY24E	FY25E
Equity capital	128	128	137	137	137	137
Reserves	1,540	1,788	2,661	3,015	3,585	4,337
Net worth	**1,668**	**1,916**	**2,798**	**3,152**	**3,723**	**4,475**
Minority Interest	(0)	7	20	20	20	20
Provisions	43	49	45	12	14	17
Debt	1,218	1,348	1,172	1,147	1,072	962
Total Liabilities	**2,929**	**3,320**	**4,035**	**4,331**	**4,829**	**5,474**
Fixed assets	437	443	465	880	1,262	1,274
Capital Work In Progress	15	12	47	35	48	28
Other Intangible assets	40	42	74	74	74	74
Goodwill	26	26	26	26	26	26
Investments	87	46	87	83	97	119
Other non current assets	37	45	47	49	57	70
Net working capital	**1,535**	**1,931**	**2,366**	**1,860**	**1,857**	**2,084**
Inventories	344	435	573	605	654	745
Sundry debtors	1,730	3,056	2,492	1,999	2,026	2,298
Loans & Advances	21	18	37	19	23	28
Other current assets	341	318	401	360	374	402
Sundry creditors	(815)	(1,748)	(1,037)	(1,027)	(1,117)	(1,285)
Other current liabilities & Prov	(85)	(148)	(99)	(97)	(102)	(105)
Cash	192	306	528	886	896	1,171
Other Financial Assets	560	468	395	438	512	629
Total Assets	**2,929**	**3,320**	**4,035**	**4,331**	**4,829**	**5,474**

Source: Company Reports, Arihant Capital Research

Financial Statements

Cashflow summary

Y/e 31 Mar (INR cr)	FY20	FY21	FY22	FY23E	FY24E	FY25E
Profit before tax	358	337	442	515	830	1,094
Depreciation	42	69	78	82	104	106
Tax paid	(121)	(91)	(116)	(139)	(224)	(295)
Working capital Δ	(504)	(396)	(434)	506	3	(227)
Change in Goodwill	(0)	-	-	-	-	-
Operating cashflow	(225)	(81)	(30)	964	712	678
Capital expenditure	(228)	(72)	(135)	(485)	(498)	(98)
Free cash flow	(452)	(153)	(166)	478	214	581
Equity raised	15	9	588	-	-	0
Investments	6	41	(41)	4	(14)	(22)
Others	47	81	39	(45)	(82)	(130)
Debt financing/disposal	422	130	(176)	(25)	(75)	(110)
Dividends paid	(15)	-	(19)	(22)	(35)	(47)
Other items	10	6	(4)	(33)	2	3
Net Δ in cash	32	115	222	358	10	275
Opening Cash Flow	159	192	306	528	886	896
Closing Cash Flow	192	306	528	886	896	1,171

Source: Company Reports, Arihant Capital Research

Ratio analysis

Y/e 31 Mar (INR cr)	FY20	FY21	FY22	FY23E	FY24E	FY25E
Growth matrix (%)						
Revenue growth	-19.0%	15.2%	6.9%	2.9%	16.9%	22.9%
Op profit growth	18.9%	11.2%	18.3%	7.9%	27.1%	26.8%
Profitability ratios (%)						
OPM	12.9%	12.4%	13.8%	14.4%	15.7%	16.2%
Net profit margin	6.2%	5.6%	6.9%	7.7%	10.6%	11.4%
RoCE	12.1%	12.1%	12.4%	11.9%	15.8%	17.6%
RoNW	15.3%	13.7%	13.8%	12.6%	17.6%	19.5%
RoA	8.1%	7.4%	8.1%	8.7%	12.5%	14.6%
Per share ratios (INR)						
EPS	1.9	2.0	2.4	2.7	4.4	5.8
Dividend per share	0.1	-	0.1	0.2	0.3	0.3
Cash EPS	2.2	2.5	2.9	3.3	5.2	6.6
Book value per share	13.0	14.9	20.4	22.9	27.1	32.5
Valuation ratios (x)						
P/E	38.3	36.3	29.8	26.0	16.1	12.2
P/CEPS	32.7	29.0	24.2	21.3	13.8	10.8
P/B	5.5	4.8	3.5	3.1	2.6	2.2
EV/EBITDA	20.4	18.4	15.9	14.2	11.0	8.4
Payout (%)						
Dividend payout	6.5%	0.0%	5.8%	5.8%	5.8%	5.8%
Tax payout	33.8%	26.9%	26.3%	27.0%	27.0%	27.0%
Liquidity ratios						
Debtor days	157	197	214	168	129	113
Inventory days	38	42	53	60	56	51
Creditor days	92	121	125	90	82	75
WC Days	103	118	142	138	103	89
Leverage ratios (x)						
Interest coverage	3.9	2.8	3.4	3.8	5.1	7.2
Net debt / equity	0.6	0.5	0.2	0.1	0.0	-0.0
Net debt / op. profit	2.1	1.9	1.0	0.4	0.2	-0.2

Source: Company Reports, Arihant Capital Research

Story in Charts

Exhibit 6: Revenue is expected to grow 13.9% CAGR over the period of FY22-FY25E.

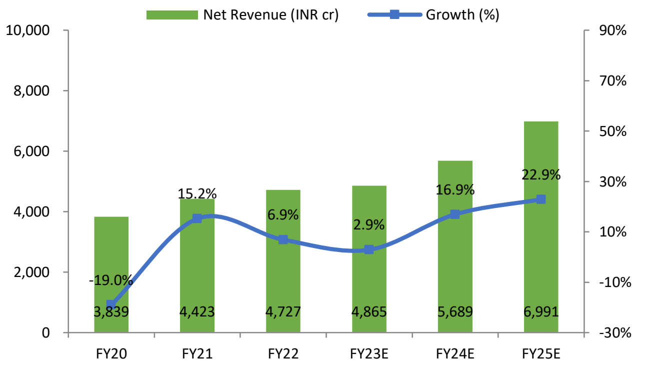


Exhibit 7: Softening of RM costs will lead to improvement in gross margins.

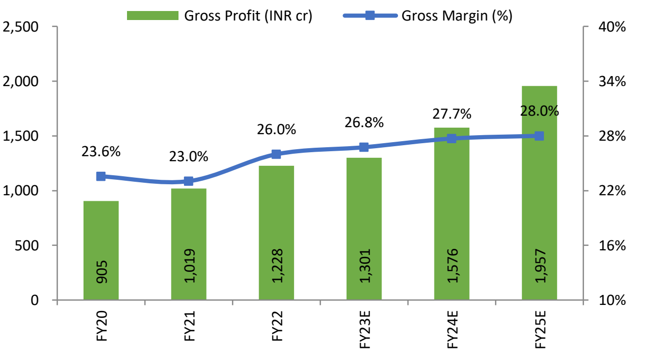


Exhibit 8: Growth in EBITDA & PAT levels

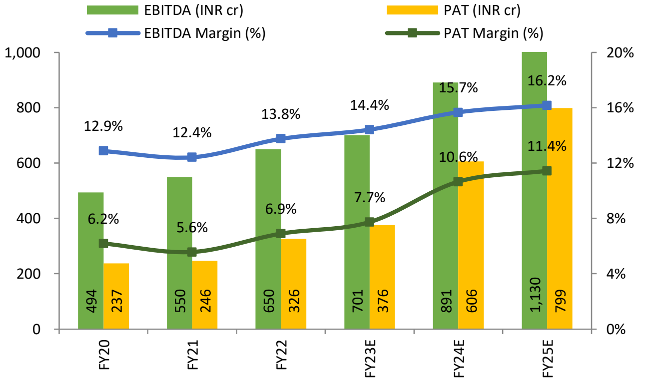


Exhibit 9: Return ratios to be improve

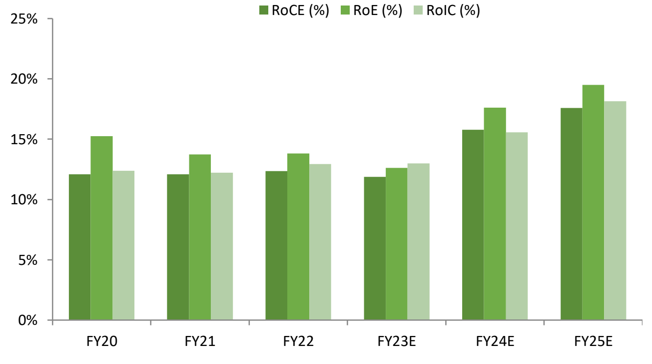


Exhibit 10: Working capital days to be improve

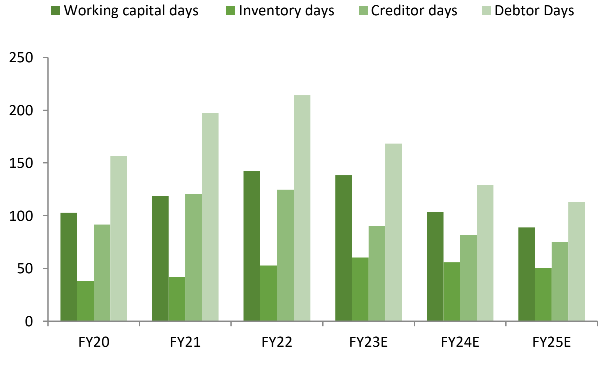
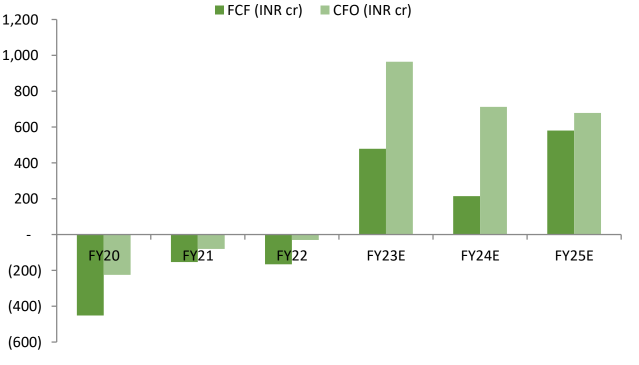


Exhibit 11: Cash flows to be improve



Source: Company reports, Arihant Capital Research

Story in Charts

Exhibit 12: Working capital in-terms of sales is expected to reduce going forward due to change in products mix.

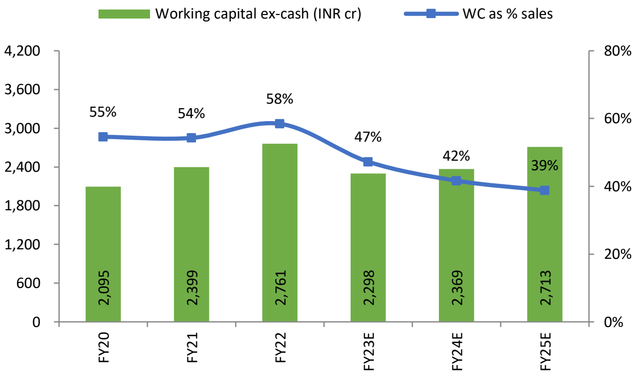


Exhibit 13: Interest cost as % of EBIT is expected to reduce going forward.

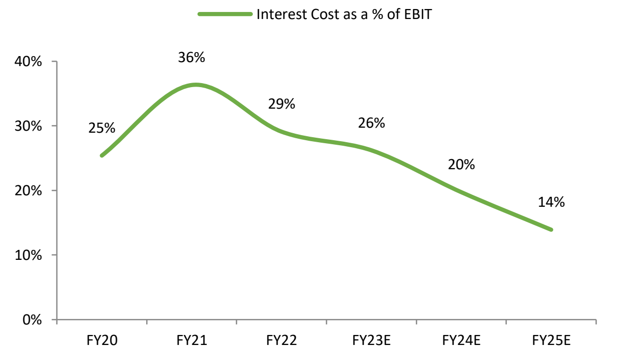


Exhibit 14: Exports revenue is expected to reach ~INR 850cr by FY23.

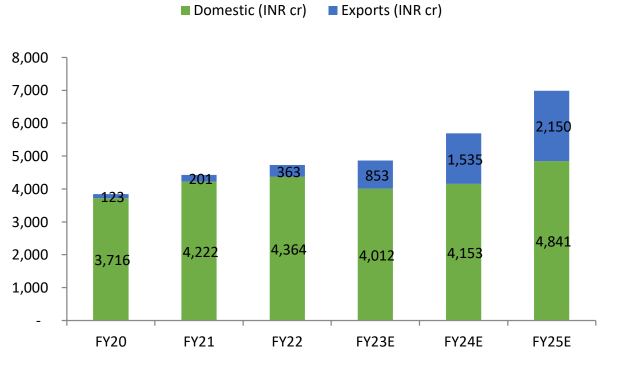


Exhibit 15: Exports revenue share is expected to reach 30% going forward.

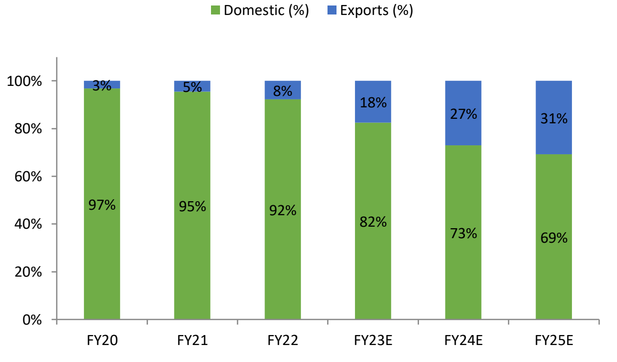


Exhibit 16: Telecom products is expected faster growth, while EPC revenue is expected remain stagnant.

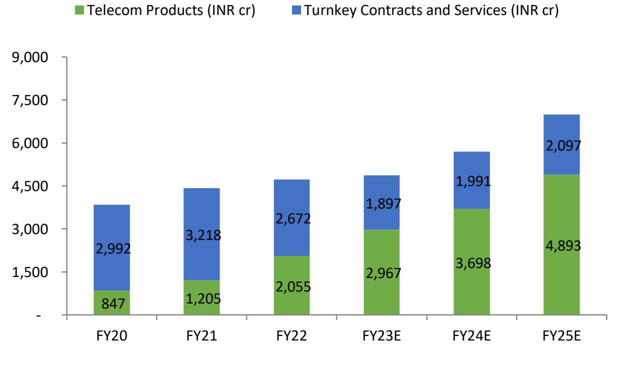
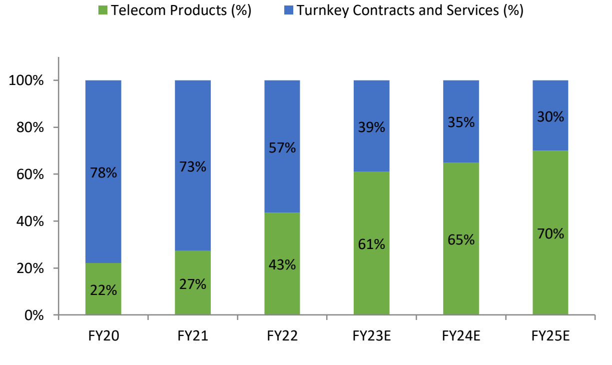


Exhibit 17: Telecom products share is expected to reach 70% going forward.



Source: Company reports, Arihant Capital Research

Story in Charts

Exhibit 18: The order book stood at INR 7,064cr which shows revenue visibility going forward.

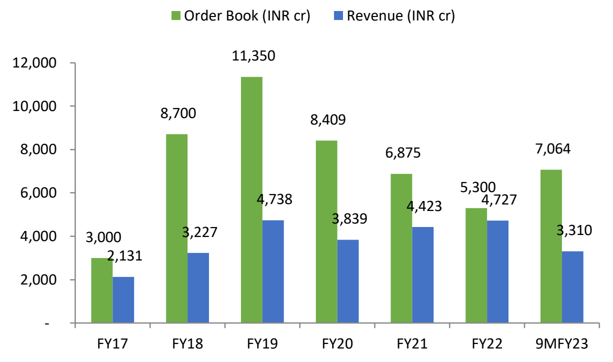


Exhibit 19: Public telecommunication revenue accounts 78% in Q3FY23.

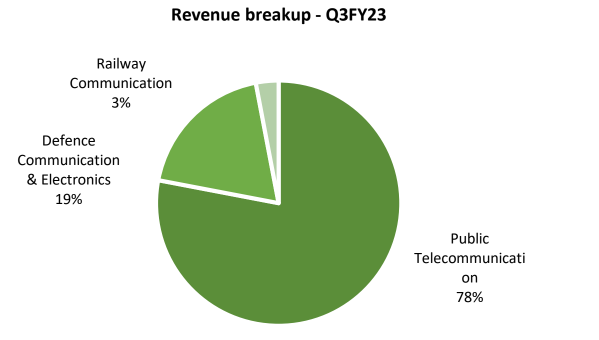


Exhibit 20: Defence order book is accounted for 31% as of Q3FY23.

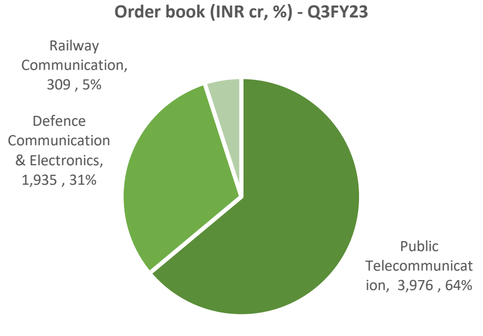


Exhibit 21: Telecom products margin witnessed improvement in Q3FY23.

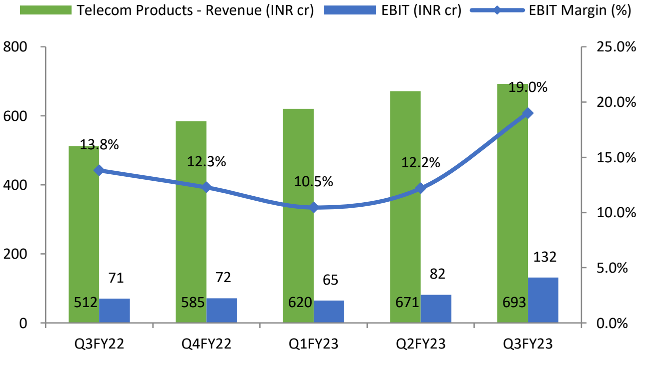


Exhibit 22: EPC margins under pressure in Q3FY23.

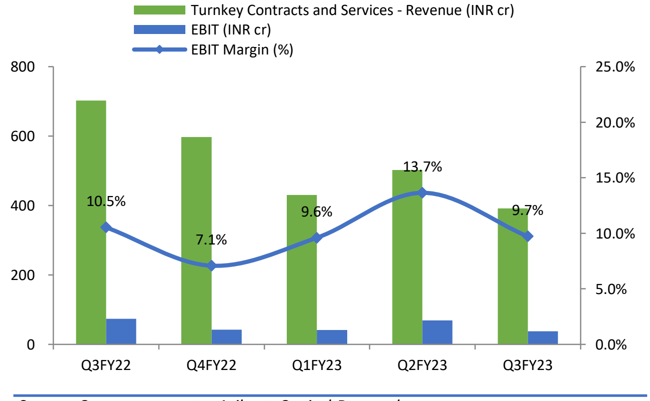
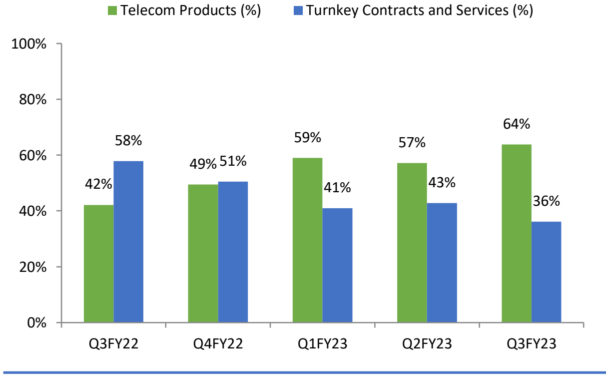


Exhibit 23: Telecom products revenue share stood at 64% as of Q3FY23. it's expected to reach 70% going forward.



Source: Company reports, Arihant Capital Research

Peer Comparison

Exhibit 24: HFCL is expected to grow 13.9% CAGR over the period of FY22-25E.

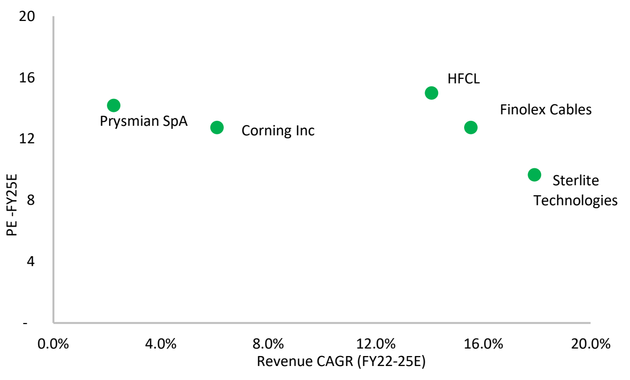


Exhibit 25: HFCL EBITDA margin is expected around 16% by FY25E. Sterlite tech margins are slightly higher than HFCL, because HFCL is importing glass preform for manufacturing while Sterlite technologies have backward integration for glass preform.

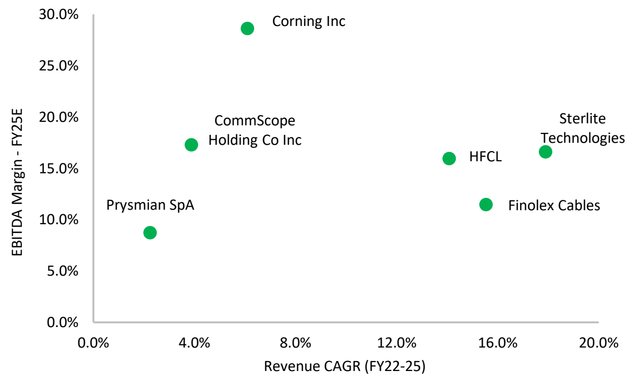


Exhibit 26: HFCL Margin is expected to improve going forward.

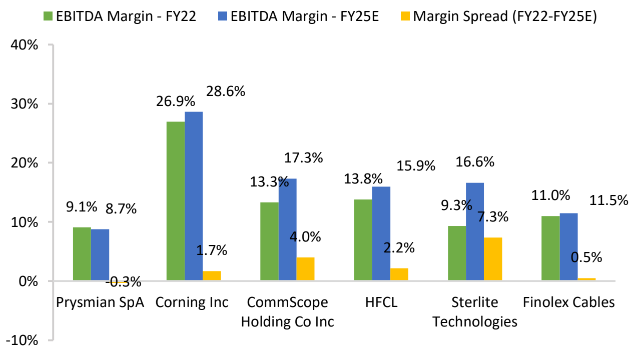


Exhibit 27: HFCL EVA spread is better the peers.

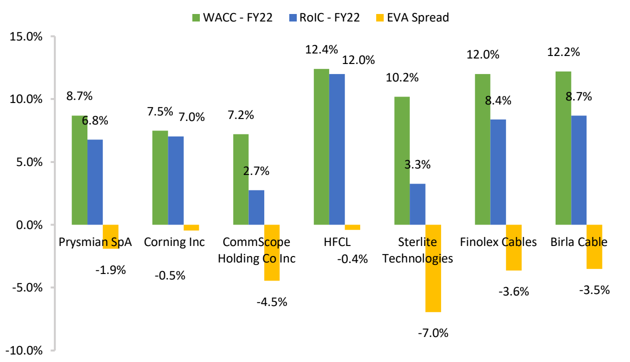


Exhibit 28: HFCL RoIC was enough to cover its WACC compared to peers.

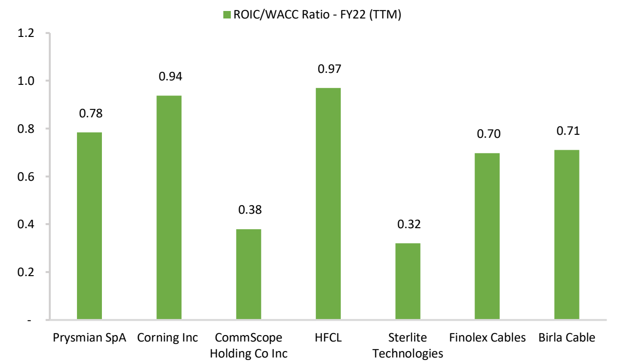
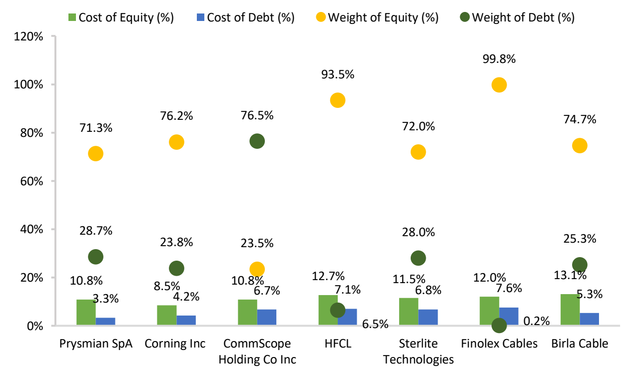


Exhibit 29: HFCL has lower weight of debt which indicates healthier balance sheet.



Source: Bloomberg, Arihant Capital Research

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Stock Rating Scale	Absolute Return
BUY	>20%
ACCUMULATE	12% to 20%
HOLD	5% to 12%
NEUTRAL	-5% to 5%
REDUCE	-5% to -12%
SELL	<-12%

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