

Mahindra Satyam

Rs84
UNRATED

IT Services

Challenges not yet abated!

Mkt Cap: Rs99bn; US\$2.2bn

□ Event

Mahindra Satyam (43% subsidiary of Tech Mahindra) reported its unaudited accounts for Q1FY11 and Q2FY11.

□ Key takeaways

Financials: The Mahindra Satyam (M-Sat) management shared unaudited accounts, including consolidated income statement and balance sheet. See exhibits on pages 2 and 3 for details.

Headline numbers: Mahindra Satyam reported revenues of Rs12.5 bn (US\$273m) and Rs12.4 bn (US\$ 268m) for Q1FY11 and Q2FY11, respectively. Consolidated Q2FY11 revenues declined by ~2% qoq in USD terms; revenues were flat in INR terms. Recurring EBIT margin declined from 5.0% in Q1 to 2.5% in Q2 primarily on the back of wage hikes. Q2 net profit before extraordinary items came in at Rs317m (down 70% qoq), while net income after extraordinary items was Rs233m (down 76% qoq). Reduced profits were driven by lower operating margin, lower other income and higher tax provision.

Employee details: Total headcount at the end of Q2 was 28,068 – qoq net hiring of 346 (1% of quarter ago-base); 1H net hiring of ~1,070 (~4% of FY10 base). The company actively hired employees from engineering and management colleges and also laterally using an internal employee referral program. The company is operating at ~71% employee utilization. BPO subsidiary has ~2,500 employees. Mahindra Satyam gave across the board wage hikes (~3% for onsite and ~15% for offshore employees) starting Q2FY11 to retain the existing employees. Attrition has inched down to ~25% - much lower from the levels seen in the recent past; however, still continues to be closer to higher end of industry's attrition levels.

Key verticals and deal wins: Management highlighted that they continue to see traction from manufacturing, telecom, media and entertainment verticals, while healthcare and life-sciences are still lackluster. From service line perspective, integrated engineering services and enterprise business solutions are expected to drive future growth. Till end of Q2, the company had 217 active clients (revenues greater than US\$0.25m) and is actively adding more customers (see page 2 for recent deal wins). This is much lower than 350 active clients reported for FY10.

Next steps: Management's commentary on future strategy was broadly inline with the last conference call – see our previous note, "Mahindra Satyam – Too little to bite" dated September 29, 2010. The management reiterated its intent to merge Mahindra Satyam and Tech Mahindra without specifying which entity would be retained. While we expect it to announce the merger date in next few weeks, it would take at least 9-12 months for this process to complete. The process will involve: 1) the appointment of a third party independent agency to find fair values for both entities and determine the stock swap ratio, 2) board and shareholder approval of both listed entities, and 3) approval from the high courts of Andhra Pradesh and Maharashtra.

□ Our view

As expected, there was limited information beyond unaudited financials that was shared with today's results. While Q2 results were not very encouraging, the company remained optimistic of future growth. It highlighted of using various levers to improve the operating metrics and reach industry growth and profitability levels. We do not rate Mahindra Satyam but reiterate our Outperformer rating on Tech Mahindra with a 12-month target price of Rs930.

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Mahindra Satyam notable contracts in FY11 so far

Date	Contract details
04-May-10	Signed a 3-year offshoring deal with BASF IT Services
20-May-10	Renewed the BPO services contract with GlaxoSmithKline for another 5-years
30-Jun-10	Entered into a partnership with Direct Channel Holdings (Pty) Ltd, one of Africa's leading contact centre and BPO company
30-Jul-10	Selected as the key partner for UID project along with Morpho
13-Oct-10	Signed deal with Commonwealth of Kentucky, Cabinet for Health and Family Services
11-Nov-10	Signed a SAP implementation contract with IRDA

Source: Company, Media sources

Income Statement

(Rs m)	FY09	FY10	Q1FY11*	Q2FY11*	QoQ* (%)
Revenues (US\$ m) - est.	1,894	1,158	273	268	(2.2)
Exchange rate (Rs/USD) - est.	46.52	47.34	45.64	46.44	
Revenue	88,126	54,810	12,480	12,424	(0.4)
Cost of revenue	60,737	39,811	8,677	9,136	5.3
Gross profit	27,389	14,999	3,803	3,288	(13.5)
Gross margin (%)	31.1	27.4	30.5	26.5	
Total Operating expenses	24,372	10,430	2,589	2,553	(1.4)
Operating profit (EBITDA)	3,017	4,569	1,214	735	(39.5)
Operating margin (%)	3.4	8.3	9.7	5.9	
Depreciation and amortization	3,263	2,144	594	429	(27.8)
EBIT	(246)	2,425	620	306	(50.6)
EBIT margin (%)	-0.3	4.4	5.0	2.5	
Interest expense	621	329	25	25	0.0
Other income	631	1,056	732	313	(57.2)
Profit before tax and EO items	(236)	3,152	1,327	594	(55.2)
Extraordinary gain/(loss)	(79,920)	(4,169)	(79)	(84)	6.3
Profit before tax after EO items	(80,156)	(1,017)	1,248	510	(59.1)
Income tax expense	1,590	222	264	270	2.3
Net profit from operations	(81,746)	(1,239)	984	240	(75.6)
Net margin (%)	-92.8	-2.3	7.9	1.9	
Share of minority interest	22	7	9	7	(22.2)
Net income for common stockholders	(81,768)	(1,246)	975	233	(76.1)
Net margin (%)	-92.8	-2.3	7.8	1.9	
Net income recurring	(1,848)	2,923	1,054	317	(69.9)
EPS (Rs)					
- Before extraordinary items					
Basic	(2.75)	2.67	0.90	0.27	(69.7)
Fully diluted	(2.75)	2.67	0.90	0.27	(69.7)
- After extraordinary items					
Basic	(121.49)	(1.14)	0.83	0.20	(75.9)
Fully diluted	(121.49)	(1.14)	0.83	0.20	(75.9)

Source: Company; *Unaudited

Balance Sheet

Period ending (Rs m)	FY09	FY10	Q2FY11*
ASSETS			
Cash and Cash Equivalents	5,009	21,768	25,273
Inventories	10	0	0
Sundry Debtors	15,516	9,230	10,919
Loans and Advances	4,663	3,739	4,021
Other curr. Assets	2,913	4,956	4,612
Total Current Assets	28,111	39,693	44,825
Deferred Tax Assets	65	65	77
Net Fixed Assets	12,388	9,865	9,070
Investments and Associates	0	6,268	4,686
P&L account balance	26,245	27,491	26,283
Total Assets	66,809	83,382	84,941
LIABILITIES			
Current Liabilities	13,892	8,712	9,538
Provisions	14,783	15,404	16,265
Total Current Liabilities & Prov.	28,675	24,116	25,803
Long Term Debt	8,142	422	342
Deferred tax liability	48	39	51
Total Long Term Liabilities	8,190	461	393
Total Liabilities	36,865	24,577	26,196
Share Capital	1,348	2,352	2,353
Reserves and Surplus	16,097	43,947	43,868
Share application money pending allotment	0	1	3
Total Equity	17,445	46,300	46,224
Minority Interest	195	201	217
Amount Pending Investigation Suspense Account	12,304	12,304	12,304
Total Liabilities and Equity	66,809	83,382	84,941

Source: Company; *Unaudited

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