

SATYAM COMPUTER SERVICES

INR 448

*Back on track after a strong quarter*

BUY

Satyam's Q4FY07 results were ahead of our expectations. Revenues, came in at INR 17.8 bn, up 7.1% Q-o-Q and 35.4% Y-o-Y while net profit, at INR 3.9 bn, was up 16.7% Q-o-Q and 38.3% Y-o-Y. Higher other income and lower depreciation have contributed to the better-than-expected profits. EBITDA margins at 23.1% (down by 160 bps Q-o-Q) resulted in a flat EBITDA over Q3FY07.

A steady pace of client addition over the past several quarters with an increasing number of clients being migrated in the USD 1-5 mn category augurs well for the company. The company has increased its million dollar client base by over 20% and its USD 10 mn plus client base by 30% in FY07 over FY06. Though the growth rate in the top 5-client category has been slightly volatile over the past three-four quarters, the top 6-10 client category has been ramping up well for the company. The company's focus on consulting and enterprise business solutions and engineering solutions is paying off, with both registering double-digit growth.

Satyam has issued positive guidance for FY08 for revenues and EPS growth of 28-30% and 27-29% respectively in USD terms as per US GAAP, revenues and EPS growth of 20-22% and 18-20% respectively as per consolidated Indian GAAP. The difference is due to the assumption of a 6% Rupee assumption factored in.

At INR 448, the stock trades at a P/E of 16.9x and 13.6x on our FY08E and FY09E earnings respectively. We maintain our 'BUY' recommendation.

Q4FY07 result highlights

- Revenues grew 7.1% Q-o-Q at INR 17.8 bn while net profit grew 16.7% Q-o-Q at INR 3.9 bn.
- However the net income has been mainly boosted by higher other income - INR 704 mn compared to INR 102 mn and lower depreciation
- EBITDA margins have declined by 160 bps Q-o-Q at 23.1%. EBITDA in absolute INR has been flat relative to Q3FY07.
- The company added 1,265 people during the quarter taking the total headcount to 35,670
- Attrition rate for the company has come down from 17.6% to 15.7%, which is commendable.
- 35 new clients have been added during the quarter and the active client count now stands at 538
- The billing rates for the quarter have increased Q-o-Q by 0.7% for offshore, 0.6% for onsite.

Financials

Year to March	Q4FY07	Q3FY07	Growth %	Q4FY06	Growth %	FY08E	FY09E
Revenue (INR mn)	17,792	16,611	7.1	13,136	35.4	83,334	106,442
EBITDA (INR mn)	4,102	4,100	0.1	3,345	22.6	19,751	24,999
EBIT (INR mn)	3,748	3,706	1.1	2,973	26.1	17,826	22,537
Net profit (INR mn)	3,936	3,372	16.7	1,249	215.2	15,528	19,316
EPS basic (INR)	6.0	5.1	16.3	4.4	36.3	25.8	31.9
PE (x)						18.4	14.9
EV/EBITDA (x)						13.7	10.3
Mkt. cap / Rev. (x)						3.8	3.0

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Reuters : SATY.BO

Bloomberg : SCS IN

Market Data

52-week range (INR) : 890 / 396

Share in issue (mn) : 667.2

M cap (INR bn/USD mn) : 298.9 / 7,103.2

Avg. Daily Vol. BSE/NSE('000) : 3,926.1

Share Holding Pattern (%)

Promoters : 9.1

MFs, Fls & Banks : 11.3

FIs : 48.2

Others : 31.4

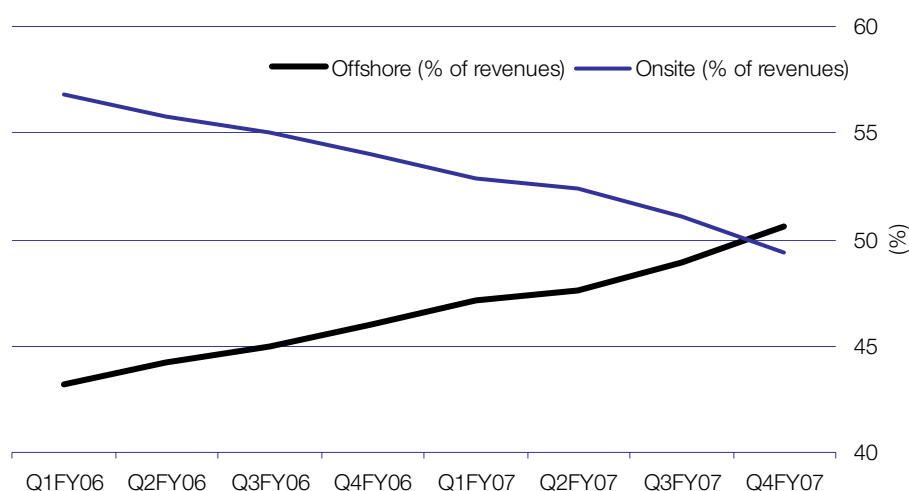
*** Guidance for FY08 positive**

In USD terms, guidance for revenue growth in FY08 is 28-30% and that for EPS 27-29%. However in INR terms the company is factoring in 6% rupee appreciation and hence revenue guidance is at 20-22% and EPS growth at 18-20%.

*** Offshore revenues on an uptrend backed by consistent double-digit volume growth**

Satyam has been consistently increasing its offshore revenues, leading to a healthier revenue mix—from 43.2% in Q1FY06 to 50.6% now, exceeding the contribution from onsite for the first time (see chart 1). While offshore revenues have been increasing at a CQGR of 10.8% through the four quarters in FY07, onsite revenues have increased at a CQGR of 5.8%, and the company’s revenues have increased at a CQGR of 8.1% over the same period. This period has seen 11% CQGR offshore volume growth through quarters.

Chart 1: Increasing offshore contribution consistently through the quarters



Source: Company, Edelweiss research

The company indicated that further shift to offshore will continue through FY08. We believe that this is one of the key levers that the company has to sustain its margins in FY08. A 1% shift in revenues to offshore has a beneficial impact on margins to the extent of 30-35 bps.

*** Scope of client mining can improve**

Satyam is increasing the share of revenues from the non-top 10 clients. However, there is significant scope to further build stronger top 10 client mining capabilities. The top client has shown anemic growth in FY07. Over the past 4 quarters, while the non-top 10 clients have grown at a CQGR of 8%, the top 5 and top 10 clients have grown at 5.7% and 8.4%, respectively (see table 1). However, within the top 10, it is the top 6-10 client category that has been growing relatively better at 13.6%.

Table 1: Top 6-10 clients are showing stronger traction than the rest (CQGR in FY07)

	Contribution to revenues (%)	Contribution per client (avg) (%)
Top client	1.0	1.0
Top 2-5	7.8	8.4
Top 6-10	13.6	13.6
Non-Top 10	8.0	4.3

Source: Company, Edelweiss research

* **Traditional dominance in enterprise applications will drive value growth**

Satyam with over 8000 professionals in its ERP practice is among the most significant Indian vendors addressing the enterprise solutions space (package implementation). The company has diversified in a balanced way between the SAP ecosystem and the Oracle System thus benefiting from deployment drivers operating for both of these globally eminent software service providers.

Enterprise Solutions and Consulting contribute significantly to Satyam's revenues (42.6% in Q4FY07) and has been growing CQGR of 10% in FY07. This accounts for about 50% of the incremental revenues for Satyam in FY07 over FY06. At USD 605 mn for FY07 this is ahead of Infosys' package implementation practice (USD 541 mn in FY07) and also of TCS (USD 525 mn in FY07). In addition, its revenues in this practice for Q4FY07 have been ahead of its closest peers.

The outlook for this segment is bright and we believe that Satyam should continue to lead the growth in this segment within the industry.

* **Getting a toehold in the large deals**

With its breakthrough win of a USD 200 mn engagement with AMD, Satyam has announced its entry in the mega multi-million multi-year contract club. Satyam has indicated that it has won three large deals in FY07 as against two in FY06 (size not specified).

Satyam is growing its infrastructure management practice as this is emerging as an essential component in several large deals. However, the company has also mentioned that several large deals in the fray cut across geographies and services without any bias towards any specific vertical(s). It is currently pursuing about 10-15 of them.

However, alternatively we believe that Satyam can further strengthen focus on its mid-tier clients (those ranked between 20 and 50 in the revenue pecking order) to achieve growth. Several of them could be potentially USD 50 mn plus accounts.

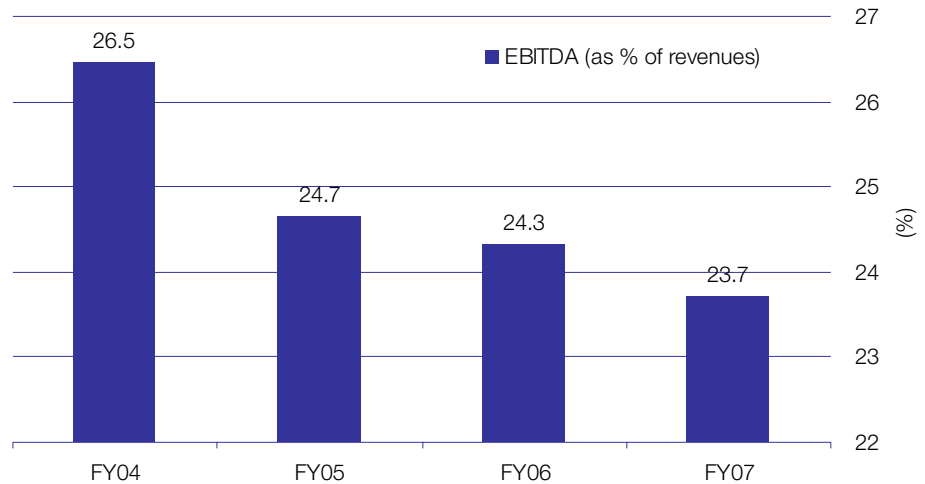
* **Reining in attrition**

Satyam historically has had annualized attrition in excess of 18% through the quarters (19.2% in FY06). The company has done an admirable job of keeping the quarterly attrition down to 13% in Q4FY07. The company has paid particular attention to implementing better employee retention such as job rotation (exposure to different technologies and domains) which has had the beneficial impact of stemming voluntary departures of mid-level professionals. The company has also emerged as the number 2 employer in India in the Hewitt "Best Employers in India" survey.

* **Ability to maintain margins will be watched**

Satyam's performance over the years on maintaining EBITDA margins has been less encouraging (see chart 2).

Chart 2: Satyam's EBITDA margins have been trending down



Source: Company, Edelweiss research

* **The company has indicated various levers to maintain margins in FY08 which include**

- ◆ Broadening of the employee pyramid. We believe that the mix of addition of entry-level professionals to lateral professionals could be 50:50 in FY08 at a gross level as against a 45:55 addition mix in FY07
- ◆ Improving profitability of the subsidiaries which can improve EBIT margins upto 50 bps
- ◆ Further shift offshore. A feasible 1.5% revenue shift to offshore can beneficially impact margins to the tune of 50 bps.
- ◆ Productivity improvements emanating from several factors such as a greater The company has already factored in the adverse impact of a 12%-15% offshore salary hike and 3%-5% onsite salary hike and a further 2% appreciation of the INR versus the USD.

* **Guidance is pleasing to markets**

We believe that Satyam's FY08 guidance sends two positive messages namely its

- ◆ ability to grow revenues at near-top growth rates in the industry comparable with Tier-1 players such as Infosys, Wipro and TCS.
- ◆ confidence in sustaining margins in FY08 versus FY07. Given that operating margins in Q4FY07 have trended down and are lower than the overall margins in FY07, the company indicates that it expects to improve margins to operate at FY07 levels in FY08. This is after deduction of non-cash charges towards RSUs.

* **Outperformance of guidance is getting stronger over time**

We observe that Satyam's degree of out-performance relative to its stated guidance is getting stronger through the years. Table 2 shows that the strength of outperformance is more pronounced at the EPS growth level.

Table 2: Satyam has been outperforming guidance more strongly with time in terms of growth delivered

Under Indian GAAP

Revenues	Guided		Actual perf.	Outperformance
FY04	15.0	17.0	15.2	(10.6)
FY05	28.0	30.0	37.5	25.0
FY06	26.0	28.0	36.1	29.0
FY07	25.2	27.3	35.3	29.3

EPS	Guided		Actual perf.	Outperformance
FY04	41.8	45.0	47.7	6.0
FY05	24.5	26.6	37.5	41.0
FY06	20.0	22.0	36.2	64.5
FY07	18.0	20.0	40.0	100.0

Source: Company, Edelweiss research

This gives us further confidence that Satyam will likely outperform its guidance for FY08 factored in our estimates.

* Valuations

We believe that the focused approach that the company has adopted in pursuing large deals will enable it to ramp up growth in the future. Satyam is focusing on achieving operational efficiency going forward. We have EPS of INR 26.5 for FY08E, a growth of 23.9% over FY07 and INR 32.8 for FY09E (24% growth over FY08E). Our EPS CAGR stand at 23.8% over FY07-09E. At INR 448, the stock trades at a P/E of 16.9x and 13.6x on our FY08E and FY09E earnings respectively. We maintain our **'BUY'** recommendation.

(INR mn)

Financials snapshot								
Year to March	Q4FY07	Q3FY07	Growth %	Q4FY06	Growth %	FY07	FY08E	FY09E
Total revenues	17,792	16,611	7.1	13,136	35.4	64,851	83,334	106,442
Employee cost	10,763	9,674	11.3	7,500	43.5	38,579	49,116	62,902
Operating & admin expenses	2,927	2,838	3.1	2,291	27.8	10,894	14,467	18,541
Total expenditure	13,689	12,511	9.4	9,791	39.8	49,474	63,583	81,443
EBITDA	4,102	4,100	0.1	3,345	22.6	15,377	19,751	24,999
Depreciation	354	394	(10.1)	372	(4.8)	1,484	1,925	2,462
EBIT	3,748	3,706	1.1	2,973	26.1	13,893	17,826	22,537
Other income	704	102	592.2	(1,309)	(153.8)	1,833	1,652	1,972
Interest	74	32	129.7	17	349.7	159	74	40
PBT	4,378	3,776	16.0	1,648	165.7	15,566	17,752	22,497
Tax	442	403	9.7	397	11.3	1,520	2,231	3,181
Adjusted net profit	3,936	3,372	16.7	1,250	214.8	14,046	15,521	19,316
Minority interest				2	(100.0)	(1)	(7)	-
Reported net profit	3,936	3,372	16.7	1,249	215.2	14,047	15,528	19,316
EPS basic (INR)	6.0	5.1	16.3	4.4	36.3	21.4	25.8	31.9
% of revenues								
Employee cost	60.5	58.2		57.1		59.5	58.9	59.1
Operating & admin expenses	16.4	17.1		17.4		16.8	17.4	17.4
EBITDA	23.1	24.7		25.5		23.7	23.7	23.5
EBIT	21.1	22.3		22.6		21.4	21.4	21.2
Reported net profit	22.1	20.3		9.5		21.7	18.6	18.1
Tax rate	10.1	10.7		24.1		9.8	12.6	14.1

* Q3FY06 and FY06 nos. exclude Sify stake sale profit

Company Description

Satyam is the fourth-largest IT services company in India. It offers a range of IT services catering to verticals such as manufacturing, banking & financial services and insurance, telecom-infrastructure-media-entertainment-semiconductors (TIMES), and healthcare, among others. Satyam has the largest ERP practice amongst offshore vendors, having competencies in implementation of enterprise packages such as Oracle, SAP, PeopleSoft, and JD Edwards. Satyam's presence spans 55 countries, across six continents. Currently ~ 42% of its revenues were contributed by the ERP practice. The company has a client base of 620 across the globe and employs over 35,670 professionals across IT and BPO services. The number of associates including the subsidiaries and joint ventures stood at 39,552.

Investment Theme

Satyam has, over the past 8-12 quarters, successfully de-risked its revenues and achieved success in growing relationships with other than the top 15-20 accounts. Recent initiatives at Satyam include growing practices such as engineering and infrastructure segments, which have huge untapped potential. Satyam has recognized the need to focus on large deals and formed strategic deals group (SDG) to pursue and filter large deal opportunities. We believe Satyam can benefit with recent initiatives and enhance its revenues by cross-selling services to existing and new clients.

Key Risks

Key risks to our investment theme include: (a) a slowdown in US IT spending; (b) supply side constraints—salary hikes and attrition; and (d) appreciation of rupee against US dollar.

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INDIA RESEARCH

SECTOR

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RATING INTERPRETATION

Buy	Expected to appreciate more than 20% over a 12-month period	Reduce	Expected to depreciate up to 10% over a 12-month period
Accumulate	Expected to appreciate up to 20% over a 12-month period	Sell	Expected to depreciate more than 10% over a 12-month period
Trading Buy	Expected to appreciate more than 10% over a 45-day period	Trading Sell	Expected to depreciate more than 10% over a 45-day period

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