

SATYAM COMPUTER SERVICES

INR 454



To guide higher or not?

BUY

"To guide higher or not?" is a follow up to our report *To guide or not to guide*, dated March 26, 2008. In this report, we examine the possibility of Satyam Computer Services (Satyam) issuing an initial guidance for FY09 higher than that of Infosys. In doing so, we have investigated the nature of Satyam's guidance in the past in different environments and teased out the core dynamics of its guidance process. We present five conclusions of our study below:

1. *Not an unblemished record; performance versus promise got off to a rocky start.*
2. *Revenue outperformance vis-à-vis the first issued initial guidance (given in Q4 of the preceding fiscal for the coming fiscal) is at an all-time high in FY08.*
3. *There is no skew in sequential guided growth in revenues through the four quarters; however, outperformance relative to guidance is skewed towards the first half.*
4. *Substantial visibility in revenue outperformance vis-à-vis the first guidance (about 75% of annual outperformance) is known by Q2 (H1) of the fiscal. Visibility is usually front ended.*
5. *Occasion to break with the tradition of guiding in line with Infosys presents itself today. Satyam could guide for 22-24% and 19-21% growth (INR) in revenues and EPS respectively for FY09.*

* **Outlook and valuations: Maintain 'BUY'**

We also note that during the period of recent strength, the stock's discount relative to Infosys has narrowed of late, perhaps also a reflection of investors' expectations of a revenue growth guidance that should exceed that of Infosys this time around. The stock currently trades at 14.3x FY09E (about 14% discount to Infosys). We maintain our 'BUY' rating on the stock.

1. *Not an unblemished record; performance versus promise got off to a rocky start*

Satyam began issuing quarterly guidance in Q1FY02, around the same time as Infosys. It also provided operating profit margin (OPM) guidance, a practice it has long since discontinued. The company's performance in the first two years (till FY03) was marked by some inconsistency, especially on EPS. In fact, the company brought down the annual EPS (INR) guidance in the very second quarter of its history (Q2FY02) and this score of retaining the initial annual EPS guidance remained patchy right through FY03 (see table 1). Also, on two of the seven occasions, Satyam delivered below the quarterly target OPM range, while exceeding it twice. Effective FY04, Satyam discontinued giving OPM guidance. We attribute this uneventful beginning to two factors: (a) difficulties in the environment during 2001-03; and (2) relative lack of maturity in managing guidance expectations.

Financials

Year to March	FY07	FY08E	FY09E	FY10E
Revenues (INR mn)	64,851	84,175	107,574	133,195
Rev. growth (%)	35.3	29.8	27.8	23.8
EBITDA (INR mn)	15,377	18,291	24,247	31,707
Net profit (INR mn)	14,047	17,039	21,341	24,708
Shares outstanding	667.2	671.0	674.0	674.0
Adj. EPS basic (INR)	21.1	25.4	31.7	36.7
EPS growth (%)	38.0	20.6	24.7	15.8
P/E (x)	21.6	17.9	14.3	12.4
EV/EBITDA (x)	17.2	13.7	9.9	7.1
ROE (%)	27.9	26.1	26.0	24.2

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Reuters : SATY.BO
Bloomberg : SCS IN

Market Data

52-week range (INR) : 522 / 305
Share in issue (mn) : 669.5
M cap (INR bn/USD mn) : 304.5 / 7,607.6
Avg. Daily Vol. BSE/NSE ('000) : 3,433.8

Share Holding Pattern (%)

Promoters : 8.8
MFs, Fls & Banks : 11.7
Fls : 49.0
Others : 30.5

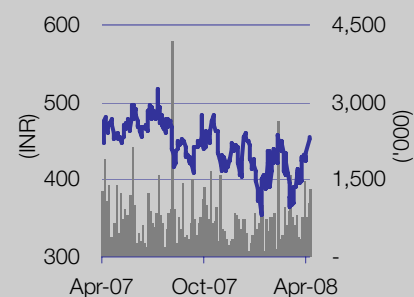


Table 1: Satyam’s track record of meeting guidance was patchy in FY03, but is broadly on track subsequently

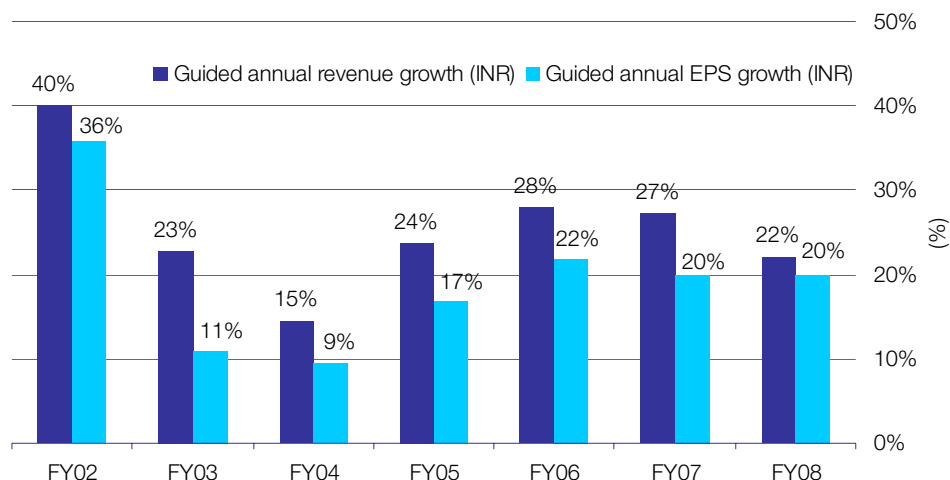
	FY02	FY03	FY04	FY05	FY06	FY07	FY08
No. of times through the quarters Satyam has							
(a) fallen short of quarterly EPS guidance range	0/4	3/4	1/4	0/4	0/4	0/4	1/4*
(b) fallen short of quarterly revenue guidance range	0/4	1/4	0/4	0/4	0/4	1/4	0/4
No. of times through the quarters Satyam has							
(a) lowered its annual outlook for EPS	1/4	2/4	0/4	0/4	0/4	0/4	1/4*
(b) lowered its annual outlook for revenues	0/4	2/4	0/4	0/4	0/4	1/4	0/4
No. of times through the quarters Satyam has							
guided for a sequential (quarterly) decline in revenues	0/4	1/4	0/4	0/4	0/4	0/4	0/4
Has Satyam							
(a) fallen short of initial annual EPS guidance range?	N	Y	N	N	N	N	N
(b) fallen short of initial annual revenue guidance range?	N	Y	N	N	N	N	N

Source: Company, Edelweiss research

* Owing to INR appreciation Y = Yes, N = No

What we also observe is that Satyam’s initial annual EPS growth guidance shows a considerable lag relative to its revenue growth guidance historically (chart 1), perhaps a measure of building in significant conservatism on margins. In other words, on account of its conservative EPS guidance philosophy, the company is setting itself up for handsome EPS outperformance. This is also borne out by the outperformance track record on EPS growth, which is a notch better than the track record of revenue outperformance (see chart 2). This differential trend has reversed in FY08 owing to the appreciation of the INR vis-à-vis the USD.

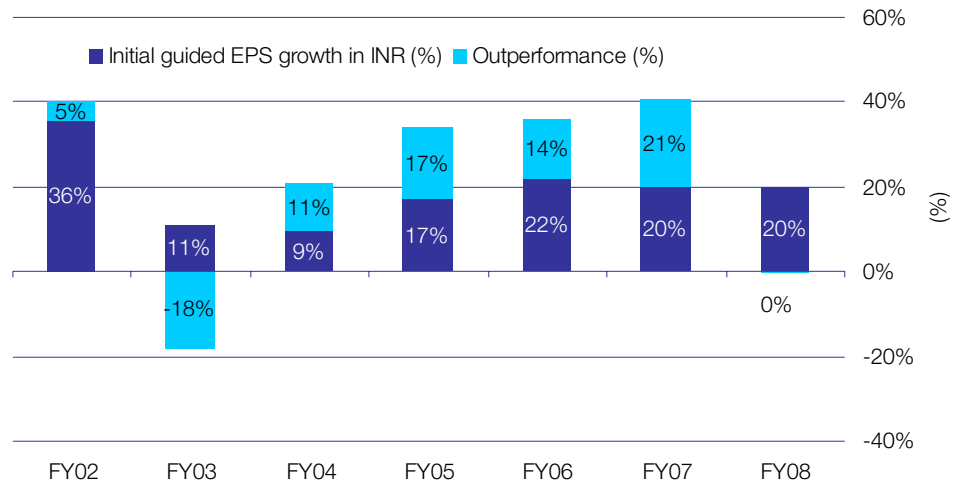
Chart 1: Annual EPS growth guidance lags annual revenue growth guidance (INR)



Source: Company, Edelweiss research

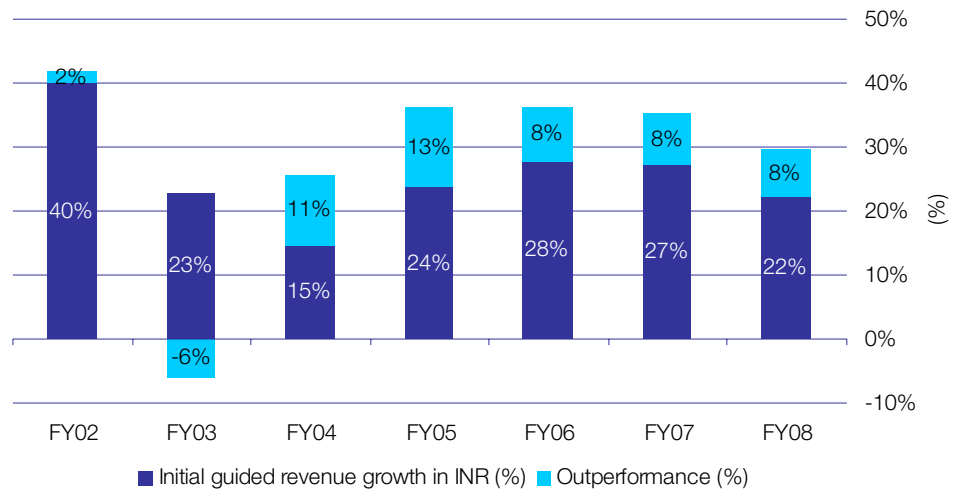
Satyam’s EPS outperformance relative to guidance exceeds its revenue outperformance, a result of a low EPS growth guidance philosophy.

Chart 2 (a): EPS (INR) outperformance relative to initial guidance (%)



Source: Company, Edelweiss research

Chart 2 (b): Revenue (INR) outperformance relative to guidance (%)

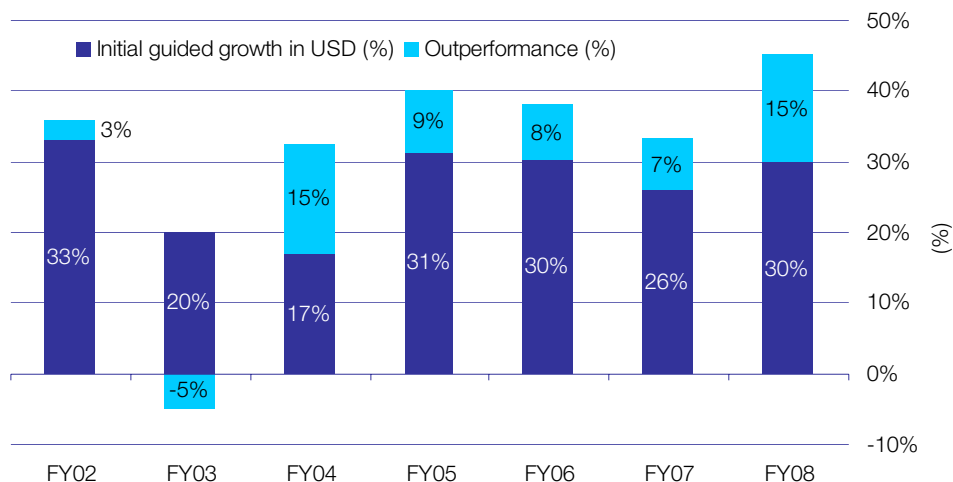


Source: Company, Edelweiss research

2. Revenue outperformance vis-à-vis the initial guidance is an all-time high today

Chart 3 shows the outperformance track record of Satyam through the years. We note that the maximum outperformance on the revenue front (in USD) in the past four years is likely to be achieved in this fiscal (FY08). Outperformance in FY04 was also considerable, but we would attribute that to a much-lower-than-trend revenue guidance growth of 17% in FY04, understandable given the spotty track record right through FY03. Notably, Infosys’s track-record of revenue outperformance has been more modest in two of the three most recent years (FY06 and FY08).

Chart 3: Satyam has failed initial revenue guidance once in its history (FY03)

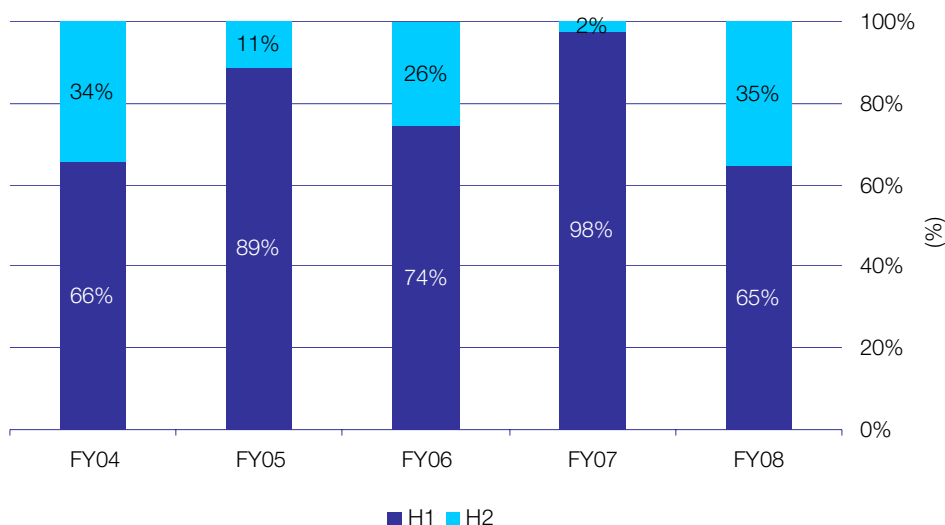


Source: Company, Edelweiss research

3. Substantial visibility in revenue outperformance vis-à-vis first guidance (over 75% of annual outperformance) is known by Q2 of a fiscal

Satyam invariably ups its guidance in Q1, Q2, and Q3 of a fiscal. The outperformance of its initially guided growth becomes especially apparent in Q1 and Q2 of a fiscal. Chart 4 shows that by Q2 of a fiscal, about 75% of the annual revenue outperformance (defined as actual revenues reported in fiscal—revenues assumed at the upper end of initial growth guidance) is uncovered in the raised annual revenue outlook in Q1 and Q2. The company also tinkers upwards its revenue outlook for a fiscal in Q3, though much of the revenue outperformance is already articulated by H1. In other words, in recent years, there is a clear upside visibility trend that peaks out during H1 or visibility in upside to the guidance is front ended. This is also the case for EPS, though the extent of front-loading of the eventual outperformance on EPS is less than it is for revenues.

Chart 4: Outperformance of initial guidance (revenues) becomes apparent by H1

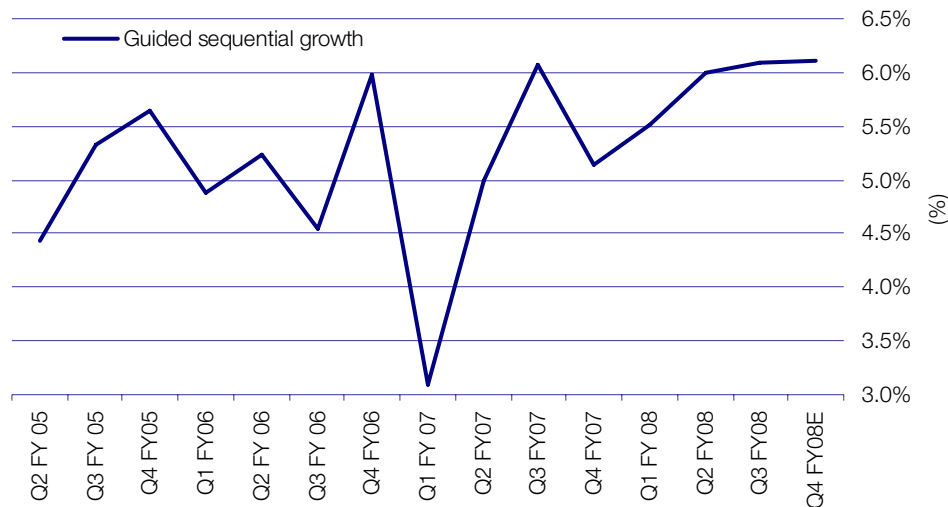


Source: Company, Edelweiss research

4. *There is no skew in guidance for sequential quarterly growth*

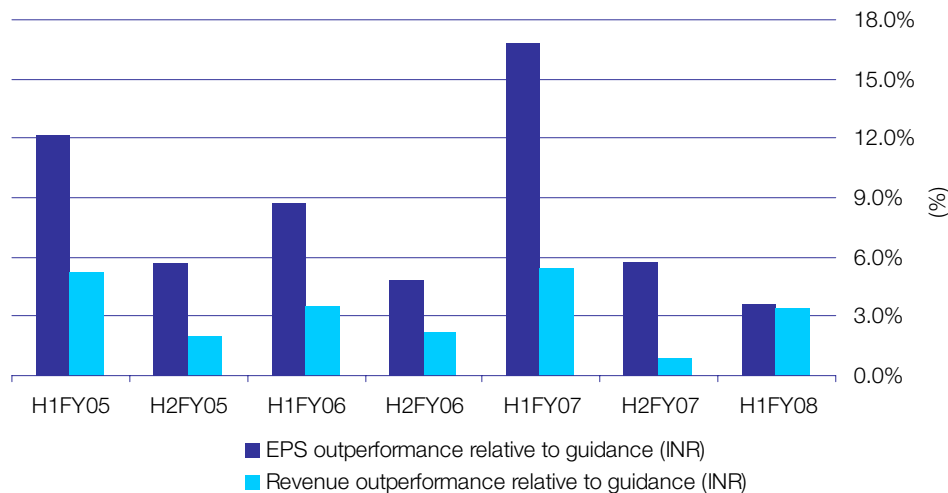
Our analysis reveals that the guided sequential revenue growth is not back ended. We observed that there is equal likelihood that Satyam guides for its strongest two quarters in a fiscal (as defined by quarterly revenue growth guided for in USD) in H2 as it does in H1. Chart 5 shows the sequential guided growth through FY03-07. This does not contradict our previous finding that substantial outperformance of the annual guidance becomes apparent by Q2 because this refers to the outlook for the whole year, not for H1. **But, we observe a skew in quarterly outperformance vis-à-vis guidance (see chart 6).**

Chart 5: Guided sequential quarterly growth (%) is not biased in favor of any quarter



Source: Company, Edelweiss research

Chart 6: Outperformance vis-à-vis guidance is higher in H1 than in H2*



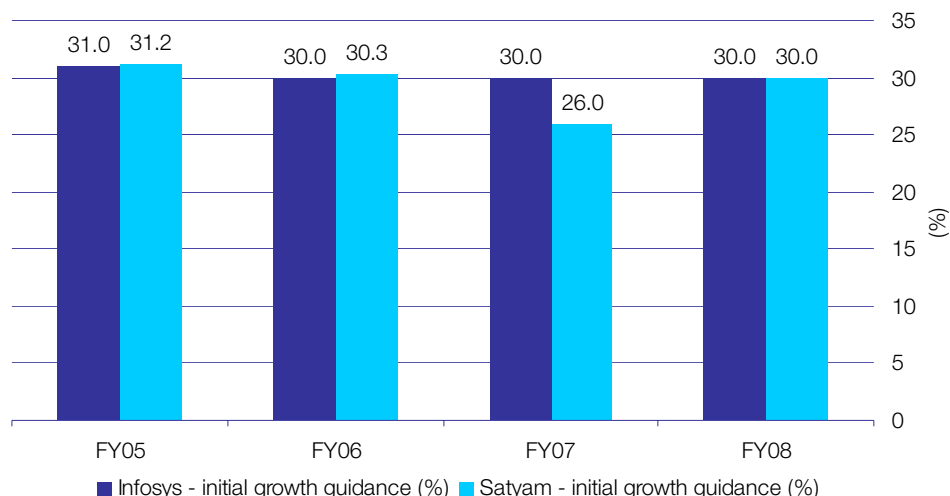
Source: Company, Edelweiss research

Note: *Outperformance = Actual sequential growth – guided sequential growth (at upper-end of the quarterly guidance band)

5. *Occasion to break with the tradition of guiding in line with Infosys presents itself today.*

We believe that in recent years, Satyam has tied its revenue guidance to Infosys (chart 7).

Chart 7: Satyam’s initial annual growth guidance in recent years has mirrored that of Infosys



Source: Company, Edelweiss research

However, in our view, Satyam is favorably placed to guide higher for FY09 than what Infosys has guided (19-21% revenue growth). We believe that Satyam will likely guide for 22-24% revenue growth for FY09 and EPS growth of 19-21%. Three factors underline this possibility:

1. There has not been a single quarter in the past fifteen quarters (since Q1FY05) when sequential growth rate in revenues (USD) has dipped below 5%. The 15-quarter CQGR is 8%, but the recent six quarter CQGR is 9.3%, emphasizing increased recent traction.
2. Package implementation is witnessing strong traction in this environment; this was particularly pointed out as an area of strength by Accenture during its Q2FY08 earnings call.
3. Near-term momentum still exists in contrast to Infosys’s commentary of near-term difficulties. We say so for two reasons:
 - a) Satyam’s near-term opportunity in implementation leverages licenses already in the system.
 - b) Difficulties that Infosys and TCS could face in the near term on account of key client issues in the BFSI segment are relatively less for Satyam given its materially lower exposure to this vertical (about 23%). Manufacturing (Satyam’s predominant vertical) is showing good traction outside the construction-related activity.

Putting all of these together, we believe that Satyam could guide for FY09 keeping an implicitly conservative 4% CQGR assumption. This indication could be in the region of a 24% annual growth for FY09E (see table 2). We also note that during the recent period of strength, the stock’s discount relative to Infosys has narrowed (chart 8), perhaps also a reflection of investors’ expectations of a revenue growth guidance for FY09 that should exceed that of Infosys this time around.

Table 2: Implied growth rate in FY09E under various CQGR assumptions through FY09E (in USD)

CQGR (%)	Annual growth (%)
3.0	21.3
4.0	24.3
5.0	27.4
6.0	30.5

Source: Company, Edelweiss research

Chart 8: Satyam's one-year forward P/E discount to Infosys has narrowed in the recent past



Source: Bloomberg, Edelweiss research

Financial Statements

Income statement					(INR mn)
Year to March	FY06	FY07	FY08E	FY09E	FY10E
Revenues	47,926	64,851	84,175	107,574	133,195
Employee cost	28,044	38,579	52,420	66,751	81,557
SG & A Expenses	8,220	5,130	4,137	18,296	22,668
EBITDA	11,662	15,377	18,291	24,247	31,707
Depreciation	1,373	1,484	1,673	2,535	3,000
EBIT	10,289	13,893	16,618	21,712	28,706
Other income	3,333	1,833	2,991	3,000	3,010
Net interest	55	159	167	40	40
Misc & prov for dec. in value of invt	1	-	-	-	-
PBT	13,565	15,566	19,442	24,672	31,676
Provision for tax	2,075	1,520	2,406	3,331	6,969
Adjusted PAT	11,490	14,046	17,036	21,341	24,708
Share of loss in associate	79	-	-	-	-
Minority interest	6	1	3	-	-
Reported net profit	11,417	14,047	17,039	21,341	24,708
Adj. EPS (basic) (INR)	15.3	21.1	25.4	31.7	36.7
CEPS (INR)	17.1	23.3	27.9	35.4	41.1
Dividend (%)	349	344	197	297	298
Dividend pay-out (%)	46	33	16	19	16

Common size metrics -as % of revenues

Year to March	FY06	FY07	FY08E	FY09E	FY10E
Employee cost	58.5	59.5	62.3	62.1	61.2
SG & A expenses	17.2	7.9	4.9	17.0	17.0
EBITDA margin	24.3	23.7	21.7	22.5	23.8
EBIT margin	21.5	21.4	19.7	20.2	21.6
Net profit margin	23.8	21.7	20.2	19.8	18.6

Growth metrics(%)

Year to March	FY06	FY07	FY08E	FY09E	FY10E
Net sales	36.1	35.3	29.8	27.8	23.8
EBITDA	34.3	31.9	18.9	32.6	30.8
Adjusted net profit	59.3	22.2	21.3	25.3	15.8
Reported net profit	60.4	23.0	21.3	25.3	15.8
EPS	36.2	38.0	20.6	24.7	15.8

Balance sheet					(INR mn)
Year to March	FY06	FY07	FY08E	FY09E	FY10E
Share capital	1,577	1,868	1,797	1,803	1,803
Reserves & surplus	41,596	55,658	71,209	89,540	111,223
Borrowings	1,027	1,479	350	352	352
Minority interest	42	-	(3)	(3)	(3)
Sources of funds	44,241	59,005	73,353	91,692	113,376
Goodwill & intangible assets	938	938	938	938	938
Equity investments in affiliate					
Property & equipment	3,832	4,269	6,823	9,789	12,288
Capital work in progress	803	3,017	425	450	451
Total fixed assets	5,573	8,223	8,186	11,177	13,677
Deferred tax	46	437	175	176	176
Investments	2	-	520	750	750
Cash & marketable securities	31,117	39,914	52,851	64,861	79,270
Account receivable	11,684	17,432	18,911	24,167	29,923
Other current assets	2,949	2,945	4,255	4,456	4,675
Total current assets	45,750	60,291	76,017	93,485	113,869
Accounts payable	4,370	5,745	6,695	7,895	9,095
Provisions	2,760	4,201	4,850	6,000	6,001
Total current liabilities & provisions	7,130	9,947	11,545	13,895	15,096
Working capital	38,621	50,345	64,472	79,590	98,772
Application of funds	44,241	59,005	73,353	91,692	113,376
Book Value per share (BV) (INR)	58	86	109	136	168

Cash flow statement					(INR mn)
Year to March	FY06	FY07	FY08E	FY09E	FY10E
Cash flow from operations	10,133	14,133	19,138	23,915	27,748
Cash for working capital	(2,605)	(4,078)	(1,190)	(3,108)	(4,774)
Net operating cashflow(A)	7,529	10,056	17,948	20,808	22,974
Net purchase of fixed assets	(2,446)	(3,827)	(1,636)	(5,525)	(5,501)
Net purchase of investments	-	(15,129)	(520)	(230)	-
Others	301	2,130	-	-	-
Cash flow from investments(B)	(451)	(17,088)	(2,156)	(5,755)	(5,501)
Dividends	(1,838)	(2,611)	(2,989)	(4,512)	(4,526)
Proceeds from issue of equity	1,399	3,016	1,431	1,507	1,501
Proceeds from LTB/STB	838	452	(1,129)	2	-
Interest paid & other items	(55)	(155)	(167)	(40)	(40)
Cash flow from financing (C)	343	702	(2,855)	(3,043)	(3,064)
Exchange rate differences (d)	12	92	-	-	-
Change in cash(A+B+C) + (D)	7,433	(6,238)	12,937	12,010	14,409

Ratios

Year to March	FY06	FY07	FY08E	FY09E	FY10E
ROE	30.0	27.9	26.1	26.0	24.2
ROCE	26.6	26.9	25.1	26.3	28.0
Debtor days	89	98	82	82	82
Fixed asset T/O	14.2	16.0	15.2	13.0	12.1

Valuation

Year to March	FY06	FY07	FY08E	FY09E	FY10E
EPS (INR)	15.3	21.1	25.4	31.7	36.7
<i>Y-o-Y growth (%)</i>	<i>36.2</i>	<i>38.0</i>	<i>20.6</i>	<i>24.7</i>	<i>15.8</i>
BVPS (INR)	57.7	86.2	108.8	135.5	167.7
PER (x)	29.8	21.6	17.9	14.3	12.4
Pr/CF (x)	23.7	19.5	16.2	12.7	11.0
P/BV (x)	7.0	5.3	4.2	3.3	2.7
EV/EBITDA (x)	23.4	17.2	13.7	9.9	7.1
EV/Revenues (x)	5.7	4.1	3.0	2.2	1.7
Market cap/revenues (x)	6.3	4.7	3.6	2.8	2.3

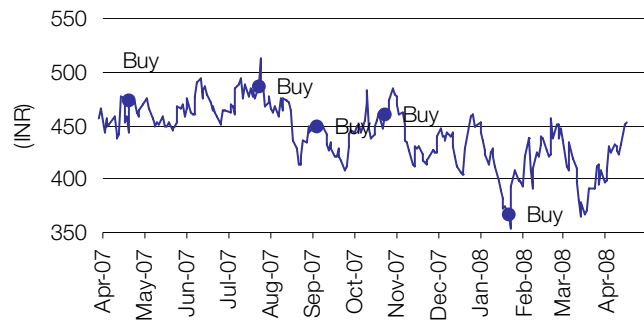
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Coverage group(s) of stocks by primary analyst(s): Information Technology:

Geometric, HCL Tech, Hexaware, i-flex, Infosys, Infotech, Mastek, Mphasis, Patni, Rolta, Sasken, Satyam, TCS, Take Solutions and Wipro

Satyam



Recent Research

Date	Company	Title	Price (INR)	Recos
15-Apr-08	Infosys Technologies	A good guidance in difficult times; <i>Result Update</i>	1,510	Accum.
15-Apr-08	HCL Technologies	Outperforming expectations; <i>Result Update</i>	245	Buy.
09-Apr-08	Mastek	Delivers on margins, Sustenance is the key; <i>Result Update</i>	322	Accum.
04-Apr-08	IT	Navigating through troubled waters; <i>Result Preview</i>		

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Accumulate	Reduce	Sell	Total
Rating Distribution*	104	57	10	1	192

* 15 stocks under review / 5 rating withheld

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	85	76	31

Rating Interpretation

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

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