

Satyam Computer

STOCK INFO.	BLOOMBERG
BSE Sensex: 10,086	SCS IN
	REUTERS CODE
S&P CNX: 2,945	SATY.BO

21 July 2006

Buy

Previous Recommendation: Buy

Rs687

Equity Shares (m)	326.3
52-Week Range	890/487
1,6,12 Rel. Perf. (%)	3/-14/-4
M.Cap. (Rs b)	224.0
M.Cap. (US\$ b)	4.8

YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
3/06A	47,926	9,820	30.3	35.9	22.7	5.2	25.8	29.5	3.9	16.2
3/07E	64,904	13,221	40.3	33.3	17.0	2.8	27.1	30.3	2.8	11.9
3/08E	83,758	15,935	48.1	19.2	14.3	3.3	26.0	29.4	2.0	9.2

- Volumes grew 7% (unconsolidated) in 1QFY07 while average billing rates declined 0.5%. Consolidated sales grew faster at 9.8% (estimate of 8%) to Rs14.4b due to rupee depreciation and higher than expected volume growth.
- Growth in revenues was driven by top 10 clients (ex-GE), which grew 8% QoQ. Growth in other clients (ex-Top 10) was also higher at 12.5%. Infrastructure management and package implementation (PI) grew in double digits at 57.6% and 12.8% respectively.
- In line with our expectation, lower utilization rates and higher personnel costs led to a 50bp decline in gross margins. SG&A expenses also increased by 40bp. EBITDA margins declined QoQ to 24.6% (estimate of 24.8%) from 25.5% in 4QFY06.
- PAT grew 24.4% QoQ in 1QFY07 (estimate of 2.5%) to Rs2.8b, driven by higher other income at Rs745m (estimate of Rs240m), lower tax rate at 9.4% (estimate of 12.8%) and lower depreciation of Rs361.7m (estimate of Rs396m).
- Satyam has revised its FY07 dollar revenue guidance by 130bp to 25.3%-27.3% from 2%-26% earlier. Higher FY07 Re/US\$ rate of 45.84 is one of the main reasons for higher revenue growth guidance under Indian GAAP (29.2%-31.2% from 25.2%-27.3%). Satyam now expects FY07 EPS of Rs38.9-Rs39.5 (up from Rs36-Rs36.6).
- We have also revised our EPS estimates upward for Satyam considering higher other income in 1QFY07 and higher than expected Rs/US\$ guidance for FY07. We now expect EPS of Rs40.3 in FY07E (revised upward by 6%) and EPS of Rs48.1 (revised upward by 5%). At CMP, Satyam is trading at 17x FY07E and 14.3x FY08E. Though we reiterate **Buy**, we continue to prefer Infosys over Satyam considering higher earnings visibility in Infosys in coming quarters.

QUARTERLY PERFORMANCE

(Rs Million)

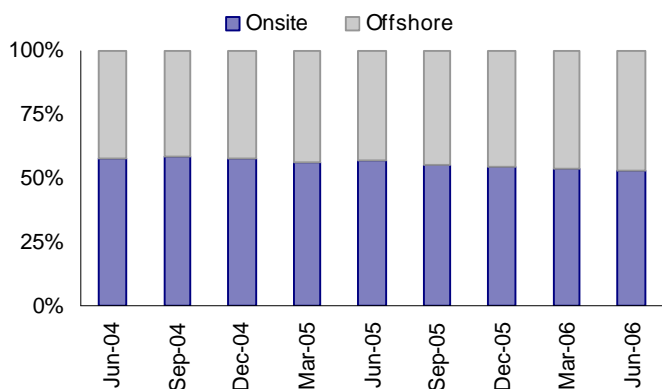
Y/E MARCH	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE		
Revenues	10,587	11,550	12,653	13,136	14,429	15,581	16,873	18,021	47,926	64,904
Q-o-Q Change (%)	9.0	9.1	9.6	3.8	9.8	8.0	8.3	6.8	36.1	35.4
Direct Expenses	6,391	6,779	7,374	7,500	8,316	9,407	10,191	10,825	28,044	38,740
Sales, General & Admin. Expenses	1,789	2,007	2,133	2,291	2,563	2,586	2,919	3,046	8,220	11,114
Operating Profit	2,407	2,764	3,146	3,345	3,550	3,587	3,762	4,151	11,662	15,050
Margins (%)	22.7	23.9	24.9	25.5	24.6	23.0	22.3	23.0	24.3	23.2
Other Income	234	316	330	289	745	361	325	488	1,168	1,919
Depreciation	313	347	341	372	362	421	456	487	1,373	1,725
Interest	5	8	27	17	26	16	17	18	55	76
PBT bef. Extra-ordinary	2,323	2,725	3,108	3,246	3,908	3,512	3,615	4,134	11,402	15,169
Provision for Tax	392	333	386	397	368	492	524	599	1,508	1,983
Rate (%)	16.9	12.2	12.4	12.2	9.4	14.0	14.5	14.5	13.2	13.1
Share of Loss in Associate Companies	29	19	24	2	0	-5	-10	-15	73	-30
Minority Interest	0	0	0	0	-1	-1	-5	2	0	-5
PAT bef. Extra-ordinary	1,902	2,373	2,697	2,847	3,541	3,027	3,105	3,548	9,820	13,221
Q-o-Q Change (%)	-7.7	24.7	13.7	5.5	24.4	-14.5	2.6	14.3	38.0	34.6

E: MOST Estimates

Standalone revenue up 10.1%, subsidiaries revenue up marginally

Standalone revenue for the quarter grew 10.1% QoQ to Rs13.9b, while subsidiaries revenue increased marginally. Nipuna grew 7.5% QoQ. Volumes grew 7% (unconsolidated) in 1QFY07, with onsite growth of 4.1% and offshore growth of 9.2% QoQ. Offshore composition of revenue increased sharply from 46% in 4QFY06 to 47.2% in 1QFY07. Onsite revenue, which was almost flat in 4QFY06, grew 8% QoQ, while offshore revenue grew faster at 13.2% QoQ.

OFFSHORE COMPOSITION CONTINUES TO INCREASE



Source: Company/ Motilal Oswal Securities

Repeat business during the quarter declined to 87.7% of revenue, while new business composition grew to 12.3%. The company added 34 clients in the quarter. Enterprise business grew strongly at 12.8%, infrastructure services grew 57.6% (albeit on a small base) while ADM services grew slower at 5.4%. Composition of ADM in overall revenue declined sharply to 48.5% from 50.7% in the previous quarter, while the Enterprise business grew to 40.3% from 39.3% in 4QFY06. Infrastructure services also grew to 5.2% of revenue from 3.7% in the previous quarter.

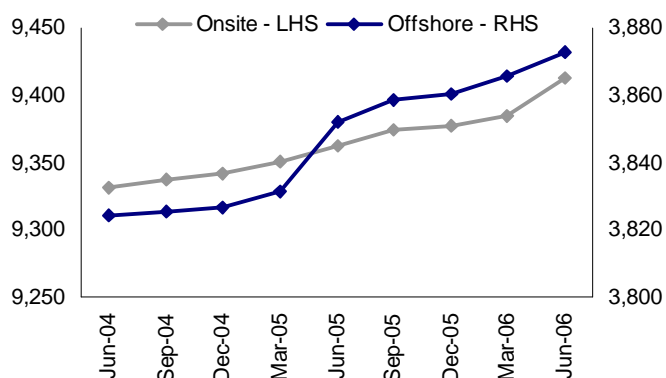
HEADING: REVENUE BY SERVICE OFFERINGS

	JUN-05	SEP-05	DEC-05	MAR-06	JUN-06
ADM					
% change QoQ	4.7	5.5	9.3	4.2	5.4
% to revenue	51.3	50.1	50.1	50.7	48.5
Enterprise Business					
% change QoQ	13.6	13.9	9.5	2.6	12.8
% to revenue	37.4	39.4	39.4	39.3	40.3
Extended engineering					
% change QoQ	9.1	-1.0	6.3	3.5	3.2
% to revenue	7.2	6.6	6.4	6.4	6.0
Infrastructure management					
% change QoQ	12.6	1.0	15.1	-7.8	57.6
% to revenue	4.2	3.9	4.1	3.7	5.2

Source: Company/ Motilal Oswal Securities

Sharp increase in revenue from new clients (which have higher billing rates) and greater proportion of revenue from higher-end services resulted in increase in billing rates by 0.3% onsite and 0.18% offshore during the quarter.

BILLING RATES ARE TRENDING UPWARD



Source: Company/ Motilal Oswal Securities

GE declined 2.4% during the quarter, while the top 5 excluding GE grew 5.2% QoQ. Contribution from GE also declined to 7.1% from 8% in 4QFY06. Top 6-10 clients and non-top clients grew strongly at 12% and 12.5% respectively.

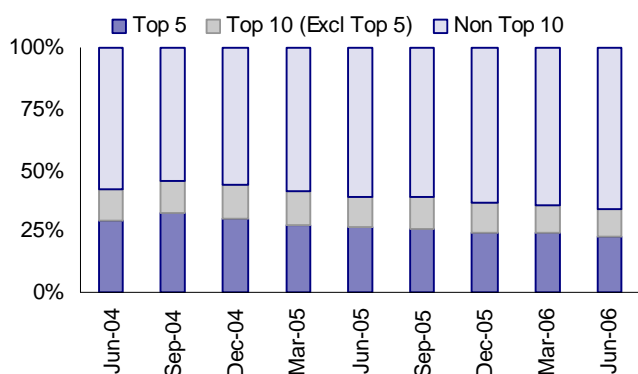
PERFORMANCE OF TOP AND NON-TOP CLIENTS (%)

	JUN-05	SEP-05	DEC-05	MAR-06	JUN-06
Top Client - GE	12.9	-2.1	14.8	-11.9	-2.4
Top 5	6.6	1.9	4.7	2.0	2.7
Top 5 (Excl. GE)	3.3	4.1	-0.7	10.6	5.2
Top 10	3.2	5.9	4.0	0.6	5.7
Top 10 (Excl. Top 5)	-3.7	15.0	2.6	-2.4	12.0
Non Top 10	12.3	9.4	12.8	4.5	12.5

Source: Company/ Motilal Oswal Securities

Non-Top clients have been growing faster over the past few quarters, with their contribution to revenue increasing from 60.6% in 1QFY06 to 65.6% in FY07. We believe that this is a healthy sign, which would help de-risk the business, potentially increase overall billing rates and result in considerable client churn over the coming quarters.

REVENUE FROM NON-TOP 10 CLIENTS ON THE RISE



Source: Company/ Motilal Oswal Securities

The focus domains of the company reported robust growth during the quarter – BFSI grew 13.2%, TIMES grew 15% and Healthcare grew 16.9%. Manufacturing grew slower at 6.1% during the quarter, due to decline in GE.

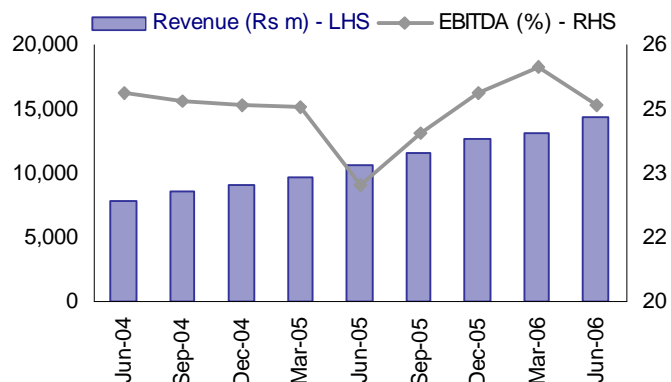
Despite the expected higher-than-industry salary hikes in 2QFY07, attrition rates (based on trailing 12 months) have increased to 19.62% from 19.17% in 4QFY06, which is significantly higher than peers. The management has clarified that annualized attrition has declined to 18.2% from +20% in 4QFY06. Satyam has added 1,123(net) new employees during 1QFY07. On a consolidated basis Satyam added 1,219 employees, including 240 in Nipuna.

Lower utilization rates, higher personnel costs and SG&A depress margins

In line with our expectations, utilization during the quarter declined by over 100bp on a blended basis during the quarter. Lower utilization and higher personnel costs led to a 50bp decline in gross margins. SG&A expenses also increased 40bp. EBITDA margins declined QoQ to 24.6% (estimate of 24.8%) from 25.5% in 4QFY06. Decline in EBITDA

margin was despite the higher offshore revenue contribution, rupee depreciation and absence of salary hikes (due in 2QFY07).

EBITDA MARGINS DECLINED IN 1QFY07



Source: Company/ Motilal Oswal Securities

Forex gains of R450m, lower tax boosts profit growth

Satyam had forex gains to the tune of Rs450m during the quarter, which pushed up other income to Rs745m (estimate of Rs240m). Effective tax rate during the quarter declined to 9.4% from 12.2% in the previous quarter due to higher offshore revenue contribution. Satyam expects tax rate to remain at FY06 levels of 13.2%, implying higher tax provision from 2QFY07 onwards. Depreciation was also lower at Rs362m v/s our estimate of Rs396m. Consequently, net profit grew 24.4% QoQ in 1QFY07 to Rs2.8b, compared with estimated growth of 2.5%.

Outlook and view

The company is planning higher-than-industry wage hikes (18% offshore and 6% onsite) in 2QFY07 (has changed its effective salary hike period from April – March to July – June) in a bid to reduce attrition from the current high levels. Besides the higher salary hike, Satyam is also introducing a restricted ESOP plan for FY07 from October 2006, which will also result in an ESOP charge from 3QFY07 onwards. We expect around 110bp impact on operating margins due to RSU charges in 3QFY07.

Satyam has revised its FY07 dollar guidance by 130bp (versus Infosys' revision by 590bp-740bp on a much larger base) to 25.3%-27.3% from 24-26% earlier. Satyam expects FY07 Re/US\$ rate to be 45.84 from the earlier rate of Rs44.8, which is one of the main reasons for higher revenue growth guidance under Indian GAAP (29.2%-31.2% from 25.2%-27.3%).

Higher other income and higher Re/US\$ assumption has resulted in significant revision in FY07 EPS guidance under Indian GAAP. Satyam now expects FY07 EPS of Rs38.9-Rs39.5 (up from Rs36-Rs36.6). This is not indicative of any company specific efficiency resulting in higher EPS

guidance; 2QFY07 operating margins will be adversely impacted due to higher salary hike, margins in 3QFY07 margins would be under pressure due to RSU charge.

We have also revised our EPS estimates upward for Satyam considering higher other income in 1QFY07 and higher than expected Rs/US\$ guidance for FY07. We now expect EPS of Rs40.3 in FY07E (revised upward by 6%) and EPS of Rs48.1 (revised upward by 5%). At CMP, Satyam is trading at 17x FY07E and 14.3x FY08E. Though we reiterate **Buy**, we continue to prefer Infosys over Satyam considering higher earnings visibility in Infosys in coming quarters.

Satyam Computer: an investment profile

Company description

Satyam is the fourth largest Indian IT services company employing more than 27,000 people. It enjoys leadership position in the package implementation services segment and services over 480 clients including Fortune 500 clients. It services top companies in every industry including GE, Ford, Merrill, DuPont, Cigna and Applied Materials.

Key investment arguments

- ✍ One of the largest beneficiaries of the current preference for offshore vendors by global clients.
- ✍ Orbit 5 initiative enabling company to improve processes and efficiency.
- ✍ Potential to get re-rated as investors are currently ignoring the qualitative changes in the company.

Key investment risks

- ✍ Frequent comparison with peers on qualitative aspects leads to dissatisfaction.
- ✍ Lacks innovation in managing cyclical trends in comparison to peers.
- ✍ Expectations are high due to comparison with peers.

Recent developments

- ✍ Crossed the US\$1b mark in terms of revenue in FY06.
- ✍ Bagged multi-million dollar, multi-year contracts from 2 global auto majors in the last quarter of FY06.

Valuation and view

- ✍ CAGR of 32.2% in sales and 27.4% in net profit over the FY06-FY08E.
- ✍ Valuations at 14.3x FY08E earnings are attractive
- ✍ **Buy** with a target price of Rs910, an upside of 32.5% from current levels.

Sector view

- ✍ Various CIO surveys indicate increasing share of offshore spending in IT budgets.
- ✍ Indian offshore vendors gaining market share in competition with MNCs.
- ✍ Prefer large companies as they win bulk of volumes while niche players benefit due to lack of competition.

COMPARATIVE VALUATIONS

		SATYAM	HCLT	PATNI
P/E (x)	FY07E	17.0	16.0	17.3
	FY08E	14.3	12.8	13.4
P/BV (x)	FY07E	2.8	3.5	1.5
	FY08E	3.3	3.4	1.4
EV/Sales (x)	FY07E	2.8	2.1	0.9
	FY08E	2.0	1.7	0.7
EV/EBITDA (x)	FY07E	11.9	10.2	5.9
	FY08E	9.2	8.0	4.5

SHAREHOLDING PATTERN (%)

	MAR.06	DEC.05	MAR.05
Promoters	14.0	14.1	15.7
Domestic Institutions	7.4	7.5	10.9
FII's/FDIs	73.5	73.6	68.0
Others	5.1	4.8	5.4

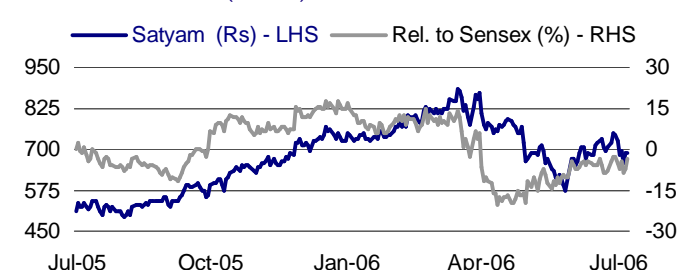
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	40.3	37.8	6.5
FY08	48.1	46.2	4.2

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
687	910	32.5	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT						(Rs Million)					
Y/E MARCH	2004	2005	2006	2007E	2008E						
Sales	25,605	35,208	47,926	64,904	83,758						
Change (%)	26.5	37.5	36.1	35.4	29.0						
Cost of Goods Sold	16,499	23,821	32,738	45,110	59,423						
SG&A	2,333	2,705	3,526	4,743	5,695						
EBITDA	6,773	8,682	11,662	15,050	18,640						
% of Net Sales	26.5	24.7	24.3	23.2	22.3						
Depreciation	1,50	1,133	1,373	1,725	2,178						
Interest	10	9	55	76	84						
Other Income	713	847	1,168	1,919	2,001						
PBT	6,326	8,387	11,402	15,169	18,379						
Tax	1,063	1,176	1,508	1,983	2,529						
Rate (%)	16.8	14.0	13.2	13.1	13.8						
PAT	5,134	7,116	9,820	13,221	15,935						
Change (%)	116	37.0	38.0	34.6	20.5						
Extra Ordinary Items	0	0	1,598	0	0						
Net Income	5,134	7,116	11,418	13,221	15,935						

BALANCE SHEET						(Rs Million)					
Y/E MARCH	2004	2005	2006	2007E	2008E						
Share Capital	633	639	649	656	663						
Preference share capital	910	910	910	910	910						
Share Premium	8,251	8,917	10,292	11,944	13,705						
Other Reserves	16,016	22,515	31,322	41,024	52,721						
Net Worth	25,810	32,981	43,173	54,534	67,999						
Minority Interest	0	0	42	50	60						
Loans	73	189	1,027	1,186	1,000						
Capital Employed	25,882	33,170	44,241	55,770	69,059						
Gross Block	8,472	10,142	13,172	16,672	21,672						
Less : Depreciation	5,978	7,057	8,402	10,127	12,304						
Net Block	2,494	3,086	4,770	6,545	9,368						
CWIP	222	693	803	500	500						
Investments	748	763	0	0	0						
Curr. Assets	25,955	33,007	45,790	58,489	73,150						
Debtors	5,928	7,805	11,684	14,989	19,433						
Cash & Bank Balance	18,154	23,701	31,117	40,632	49,198						
Loans & Advances	906	1,148	1,834	2,060	2,965						
Other Current Assets	915	247	1,108	841	1,672						
Current Liab. & Prov	3,536	4,379	7,121	9,764	13,959						
Creditors	1,508	1,720	3,323	2,900	5,131						
Other Liabilities	437	763	1,038	1,039	1,641						
Provisions	1,591	1,896	2,760	5,825	7,186						
Net Current Assets	22,419	28,629	38,669	48,725	59,191						
Application of Funds	25,882	33,170	44,241	55,770	69,059						

E: M O S t Estimates

RATIOS					
Y/E MARCH	2004	2005	2006	2007E	2008E
Basic (Rs)					
EPS	16.3	22.3	30.3	40.3	48.1
Cash EPS*	19.9	25.6	34.5	45.6	54.7
Book Value	81.7	101.2	133.1	166.4	205.2
DPS	4.0	5.2	7.1	9.4	11.2
Payout %(Incl.Div.Taxes)	24.7	23.3	23.3	23.3	23.3
Valuation (x)					
P/E		30.8	22.7	17.0	14.3
Cash P/E		26.8	19.9	15.1	12.6
EV/EBITDA		22.4	16.2	11.9	9.2
EV/Sales		5.5	3.9	2.8	2.0
Price/Book Value		6.8	5.2	4.1	3.3
Dividend Yield (%)		0.8	1.0	1.4	1.6
Profitability Ratios (%)					
RoE	21.8	24.2	25.8	27.1	26.0
RoCE	26.7	28.4	29.5	30.3	29.4
Turnover Ratios					
Debtors (Days)	85	81	75	72	72
Asset Turnover (x)	3.0	3.5	3.6	3.9	3.9
Leverage Ratio					
Debt/Equity Ratio(x)	0.0	0.0	0.0	0.0	0.0

CASH FLOW STATEMENT						(Rs Million)					
Y/E MARCH	2004	2005	2006	2007E	2008E						
Cash Flow from Operations	6,413	8,344	11,266	14,911	18,028						
Cash for Working Capital	1,727	-169	2,686	505	810						
Net Operating CF	4,687	8,512	8,580	14,406	17,218						
Net Purchase of FA	-665	-2,142	-3,140	-3,198	-5,000						
Net Purchase of Invest.	-171	-15	2,361	0	0						
Net Cash from Invest.	-836	-2,157	-779	-3,198	-5,000						
Proceeds from Pvt. Place.	375	672	1,384	1,659	1,768						
Proceeds from LTB/STB	-111	116	838	159	-1,186						
Dividend Payments	-1,381	-1,596	-2,608	-3,512	-4,233						
Net CF from Finan.	-1,116	-808	-386	-1,693	-3,651						
Free Cash Flow	4,308	5,299	4,816	10,946	10,222						
Net Cash Flow	2,735	5,547	7,416	9,515	8,567						
Opening Cash Bal.	15,418	18,154	23,701	31,117	40,632						
Add: Net Cash	2,735	5,547	7,416	9,515	8,567						
Closing Cash Bal.	18,153	23,701	31,117	40,632	49,198						

NOTES



For more copies or other information, contact

Institutional: Navin Agarwal. **Retail:** Manish Shah, Mihir Kothari

Phone: (91-22) 39825500 Fax: (91-22) 22885038. E-mail: inquire@motilaloswal.com

Motilal Oswal Securities Ltd, 3rd Floor, Hoechst House, Nariman Point, Mumbai 400 021

This report is for the personal information of the authorized recipient and does not construe to be any investment, legal or taxation advice to you. Motilal Oswal Securities Limited (*hereinafter referred as MOS*) is not soliciting any action based upon it. This report is not for public distribution and has been furnished to you solely for your information and should not be reproduced or redistributed to any other person in any form.

The report is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon such. MOST or any of its affiliates or employees shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. MOST or any of its affiliates or employees do not provide, at any time, any express or implied warranty of any kind, regarding any matter pertaining to this report, including without limitation the implied warranties of merchantability, fitness for a particular purpose, and non-infringement. The recipients of this report should rely on their own investigations.

MOST and/or its affiliates and/or employees may have interests/ positions, financial or otherwise in the securities mentioned in this report. To enhance transparency, MOST has incorporated a Disclosure of Interest Statement in this document. This should, however, not be treated as endorsement of the views expressed in the report.

Disclosure of Interest Statement

Satyam Computer

- | | |
|---|----|
| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | No |
| 3. Broking relationship with company covered | No |
| 4. Investment Banking relationship with company covered | No |

This information is subject to change without any prior notice. MOST reserves the right to make modifications and alternations to this statement as may be required from time to time. Nevertheless, MOST is committed to providing independent and transparent recommendations to its clients, and would be happy to provide information in response to specific client queries.