

Company In-Depth

8 November 2006 | 10 pages

Satyam Computers Services (SATY.BO)

Upgrading to Buy: Target to Rs510

 Rating change
 Target price change
 Estimate change

- Upgrade to Buy (1M)** — We upgrade Satyam to Buy / Medium Risk (1M) from Hold / Medium Risk (2M) due to better-than-expected quarterly performance, strong business momentum and reasonable valuation. We believe recent underperformance presents an attractive opportunity to buy the stock.
- Strong momentum for offshore continues** — Strong quarterly results and guidance upgrades reaffirmed our positive view on demand momentum across the sector. Enterprise software (considered susceptible to a US slowdown) did well. Companies like SAP also reported decent numbers and outlook. Satyam should be one of the key beneficiaries of the solid offshore momentum.
- Sharp underperformance over last one month** — Satyam has underperformed sector leader Infosys by 14% and peer HCL Tech by 8% since the start of October. With a good quarter and positive outlook, we believe Satyam should do well going forward.
- Cost pressures to remain** — Our argument on cost pressure was highlighted by ~370bp decline in Satyam's gross margin in Q2FY07. We believe that cost pressures will remain, and we are building in 126 bp and 149 bp declines in margins in FY07 and FY08 respectively.
- Raising estimates & target** — We raise earnings estimates 6-7% to factor in better-than-expected Q2 performance and a robust outlook. Our target goes to Rs510 from Rs475 on higher forecast earnings. With an expected EPS CAGR of 24.1% over FY06-FY09E, the stock appears attractively valued at 17.1x FY08E.

Buy/Medium Risk	1M
<i>from Hold/Medium Risk</i>	
Price (08 Nov 06)	Rs415.20
Target price	Rs510.00
<i>from Rs475.00</i>	
Expected share price return	22.8%
Expected dividend yield	1.0%
Expected total return	23.8%
Market Cap	Rs272,270M US\$6,101M

Price Performance (RIC: SATY.BO, BB: SCS IN)



See page 8 for Analyst Certification and important disclosures.

Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2005A	7,116	11.02	36.1	37.7	8.0	23.9	0.6
2006A	9,979	15.09	36.9	27.5	6.2	26.2	0.8
2007E	13,810	20.47	35.7	20.3	5.0	28.2	1.0
2008E	16,393	24.31	18.8	17.1	4.0	26.8	1.2
2009E	19,462	28.86	18.7	14.4	3.3	26.0	1.4

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	37.7	27.5	20.3	17.1	14.4
EV/EBITDA adjusted (x)	28.9	21.0	15.7	12.4	9.9
P/BV (x)	8.0	6.2	5.0	4.0	3.3
Dividend yield (%)	0.6	0.8	1.0	1.2	1.4
Per Share Data (Rs)					
EPS adjusted	11.02	15.09	20.47	24.31	28.86
EPS reported	11.02	15.09	20.47	24.31	28.86
BVPS	51.65	66.53	83.72	103.14	126.12
DPS	2.50	3.50	4.00	5.00	6.00
Profit & Loss (RsM)					
Net sales	35,208	47,926	66,112	86,911	109,843
Operating expenses	-27,660	-37,637	-52,480	-70,202	-89,498
EBIT	7,549	10,289	13,631	16,709	20,346
Net interest expense	859	1,113	1,640	1,814	2,154
Non-operating/exceptionals	-22	-1	0	0	0
Pre-tax profit	8,386	11,401	15,272	18,524	22,500
Tax	-1,176	-1,509	-1,463	-2,130	-3,037
Extraord./Min.Int./Pref.div.	-95	87	1	0	0
Reported net income	7,116	9,979	13,810	16,393	19,462
Adjusted earnings	7,116	9,979	13,810	16,393	19,462
Adjusted EBITDA	8,682	11,662	15,251	18,752	22,793
Growth Rates (%)					
Sales	37.5	36.1	37.9	31.5	26.4
EBIT adjusted	34.3	36.3	32.5	22.6	21.8
EBITDA adjusted	28.2	34.3	30.8	23.0	21.5
EPS adjusted	36.1	36.9	35.7	18.8	18.7
Cash Flow (RsM)					
Operating cash flow	6,915	7,689	10,829	12,244	15,970
Depreciation/amortization	1,133	1,373	1,620	2,043	2,447
Net working capital	-537	-2,685	-2,597	-4,378	-3,786
Investing cash flow	-800	-1,292	-2,006	-2,736	-3,110
Capital expenditure	-1,839	-3,167	-3,646	-4,550	-5,264
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	-565	1,092	-2,021	-3,696	-4,436
Borrowings	107	838	265	0	0
Dividends paid	-1,800	-2,562	-2,957	-3,696	-4,436
Change in cash	5,550	7,489	6,801	5,812	8,424
Balance Sheet (RsM)					
Total assets	37,549	51,371	66,092	80,439	98,590
Cash & cash equivalent	23,701	31,117	37,920	43,732	52,156
Accounts receivable	7,805	11,684	15,939	20,716	26,182
Net fixed assets	3,779	5,573	7,599	10,106	12,923
Total liabilities	4,568	8,157	11,354	13,004	16,129
Accounts payable	2,483	4,370	7,157	7,822	9,886
Total Debt	189	1,027	1,292	1,292	1,292
Shareholders' funds	32,981	43,214	54,738	67,435	82,461
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	24.7	24.3	23.1	21.6	20.8
ROE adjusted	23.9	26.2	28.2	26.8	26.0
ROIC adjusted	79.9	81.0	79.1	69.0	62.1
Net debt to equity	-71.3	-69.6	-66.9	-62.9	-61.7
Total debt to capital	0.6	2.3	2.3	1.9	1.5

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Upgrading to Buy

We are upgrading Satyam to Buy / Medium Risk (1M) from Hold / Medium Risk (2M) on the back of strong quarterly performance, good top-line momentum and reasonable valuations. Satyam has underperformed sector leader Infosys by 14% and peer HCL Tech by 8% since the start of October. Satyam now trades at over a 32% discount to Infosys – which is close to a one-year high. We have upgraded our earnings estimates by 6-7% respectively, and we raise our target price to Rs510 from Rs475 (maintaining our target multiple of 21x FY08E EPS).

Better-than-expected Q2 results

Satyam posted strong 2Q07 results – revenue of US\$346 mn was ahead of our expectations and volume growth at 9.4% was better than what we had factored into our expectations. The company hired ~4,000 employees during the quarter. Pricing remained flattish / margin uptick sequentially. Gross margins dip of ~370bp sequentially on account of wage hikes taken in the quarter were offset by lower operating expenditure (~170bp of revenues) resulting in EBITDA margins of 22.6%, in line with our expectations.

Demand for offshore services robust

Strong quarterly results across the sector highlighted that demand for offshore services remains robust. Leading companies (Infosys, TCS, etc.) also indicated that they do not see any signs of US slowdown as of now. Most of the sector players also talked about improved pricing after a long time. This in our view addresses one of the key concerns on the sector – when will a pricing uptick happen, despite such strong volume growth over last few years?

We expect Satyam to be one of the beneficiaries of this strong offshore momentum. Also, concerns of enterprise software being slower have been address by double-digit qoq growth for Satyam's package implementation revenue (US dollar terms) and healthy license revenue growth from SAP.

Enterprise software players witness good license growth

Leading enterprise software player SAP reported decent quarterly numbers for the latest reported quarter. SAP license revenue growth of 20% (constant currency) is positive and suggests that ERP licenses continue to see buoyancy in the market. Oracle has yet to report its latest quarterly results.

Satyam has underperformed

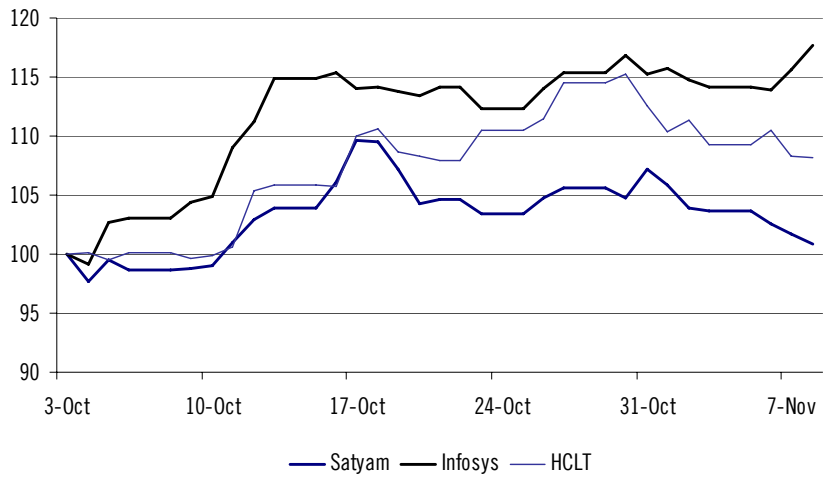
Satyam has underperformed sector leader Infosys by 14% and peer HCL Tech by 8% since the start of October. This has been in spite of decent quarterly results from Satyam and concerns on enterprise software subsiding.

Figure 1. Latest Quarter Volume Growth

	2Q07 volume growth
Satyam	9.4%
Infosys	11.2%
Wipro	7.9%

Source: Company Reports

Figure 2. Satyam Has Underperformed Infosys and HCL Tech



Source: DataStream

Satyam now trades at over a 32% discount to Infosys on 1-year forward P/E, which is a one-year high.

Figure 3. PER Valuation: Satyam Discount to Infosys



Source: Datastream, Company Reports and Citigroup Investment Research

Good growth; reasonable valuations

We now expect Satyam to witness revenue growth of 31.8% over FY06-FY09E. While cost pressures will likely continue for Satyam, we expect Satyam to report an EPS growth of 24.1% CAGR over the same period. Satyam trades at a 32% discount to Infosys. With such strong growth, we believe valuations are very reasonable and leave upside on the table. We upgrade the stock to Buy / Medium Risk (1M) with a new target price of Rs510, up from Rs475, based on 21x FY08E EPS.

Figure 4. Satyam Valuation: 12-Month Forward PER



Source: Datastream, Company Reports and Citigroup Investment Research

Acquisition target?

Satyam, with its low promoter holding of ~8%, has sometimes been viewed as a possible acquisition target. The recent acquisition of Kanbay by Cap Gemini also highlights the premium valuation which MNC's are ready to pay to ramp up offshore presence (Cap paid ~27.5x CY07 earnings). While we believe that at this point it would be speculative to invest based on this theme, it could be a significant stock price driver if M&A perceptions heighten. We also believe that this provides downside valuation support.

Figure 5. IT Services Sector: Valuation Comparisons

(Rs M)	Ticker	Rating	Price (Rs)	Market Cap (US\$ M)	Sales-FY07 (US\$ M)	EPS			PER			FY06-09 CAGR		
						FY07F	FY08F	FY09F	FY07F	FY08F	FY09F	Sales	EBITDA	EPS
Infosys	INFY.BO	1L	2,139	26,182	3,116	66.42	83.68	103.38	32.2	25.6	20.7	34.4%	32.1%	33.1%
TCS	TCS.BO	1L	1,056	23,284	4,085	40.93	49.91	61.08	25.8	21.2	17.3	29.5%	25.6%	27.2%
Wipro	WIPR.BO	1L	527	17,048	3,193	19.61	24.08	29.52	26.9	21.9	17.8	29.2%	29.0%	28.0%
Satyam	SATY.BO	1M	415	6,143	1,460	20.47	24.31	28.86	20.3	17.1	14.4	31.8%	25.0%	24.1%
HCL Tech	HCLT.BO	1M	598	4,350	1,309	30.89	35.80	42.94	19.4	16.7	13.9	26.1%	24.4%	23.4%
Patni	PTNI.BO	3M	401	1,251	587	16.64	26.09	30.11	24.1	15.4	13.3	23.6%	17.7%	12.7%
I-Flex	IFLX.BO	3M	1,524	2,790	423	39.37	51.28	68.12	38.7	29.7	22.4	27.5%	36.1%	34.1%

Source: Company Reports and Citigroup Investment Research estimates

Satyam Computers Services

Company description

Satyam is the fourth-largest IT solutions provider from India and is one of the pioneers of offshore IT services delivery. The company has over 500 clients across the globe and employs over 34,000 professionals across IT and BPO services. Satyam was an early entrant into IT consulting/package implantation work. As of 2Q07, ~40% of its revenue comes from this service line. It has domain competencies in verticals such as Manufacturing, Banking & Financial Service and Insurance among others.

Investment thesis

We rate Satyam Buy / Medium Risk (1M) with a target price of Rs510. We believe offshore IT outsourcing is now a mainstream option and Satyam - which has achieved meaningful scale with its top-five position in India - appears well positioned to benefit from growing business volumes. Over the last several quarters, volume growth has trended at over 5% qoq, and we believe this can be sustained in the medium term given the strong business environment. With revenue over US\$1 billion, Satyam becomes a strong contender for winning large deals looking at leveraging offshore. It has won at least three large deals over the last four quarters. We expect gradual margin decline (rather than steep), as wage inflation should be partially offset by positive leverage from better onsite-offshore mix, fresher hiring and improved utilization. Overall, we forecast 31.8% revenue CAGR and 24.1% EPS CAGR over FY06-09E. We see operating margins declining gradually over this period to 20.8% in FY09E from 24.3% in FY06.

Valuation

Our 12-month target is Rs510, up from Rs475 previously, based on an unchanged target multiple of 21x revised FY08E earnings. We value Satyam on a P/E basis relative to its medium-term growth potential and also on its valuation relative to peer Infosys, which is the industry benchmark. Given that we expect Satyam's earnings to grow by 24.1% CAGR over the next three years - with upside risk to estimates given the strong industry growth environment - we believe the stock could trade toward the upper end of its historical three-year trading range of 12-21x 12-month forward earnings. Satyam has traded at a 10%-40% discount to listed industry leader Infosys in the past two years due to its lower growth rates. Our forward P/E is based on a ~25% discount to our target multiple of 28x for Infosys. Applying a 21x multiple to our one-year forward estimate yields a 12-month target price of Rs510. We believe a P/E-based valuation remains the most appropriate given Satyam's profitable track record and widespread investor use of this tool.

Our target price is also supported by FY08E Price/Sales multiple of 4x, which is within the stock's historical trading range of 2-5x.

Risk

Although our quantitative risk-rating system suggests Low Risk for Satyam, we rate Satyam as Medium Risk given the similar risk ratings for other mid-sized IT peer-group companies in our coverage universe.

The key downside risks that could impede the shares from reaching our target price include: (1) A slowdown in enterprise software license revenues; (2) The supply side situation becoming more difficult; (3) Risks to earnings from a sharp US slowdown; (4) Any significant appreciation of the rupee against the US Dollar/Euro/GBP; (5) A sharp slowdown in the US economy; (6) A slowdown in the banking, financial services and insurance (BFSI) sector; and (7) limited H1B visa quotas.

Analyst Certification Appendix A-1

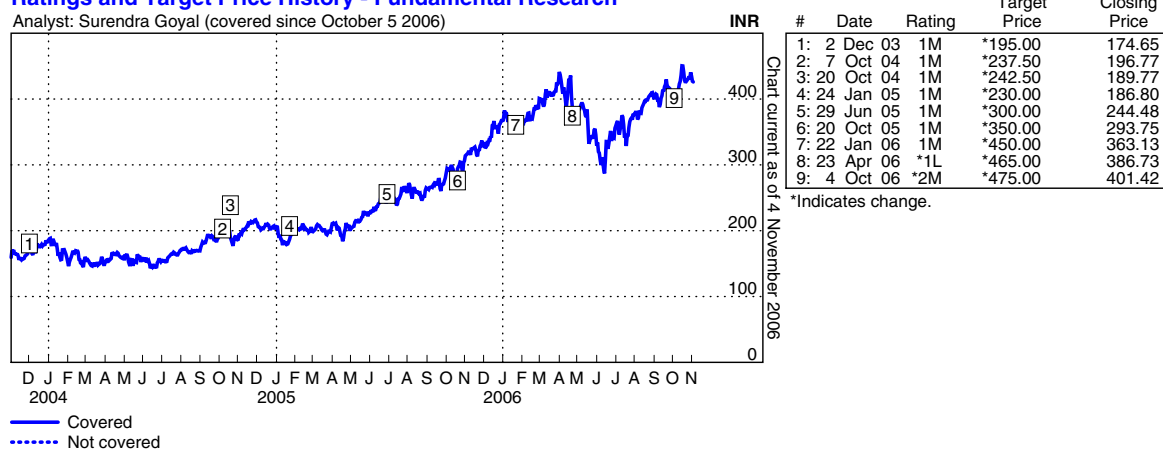
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Ratings and Target Price History - Fundamental Research

Analyst: Surendra Goyal (covered since October 5 2006)



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