3 April 2007 | 12 pages

Patni Computer Systems (PTNI.BO)

Upgrade to Buy: Valuations Cheap but No Near-term Triggers

Rating change ☑
Target price change ☑
Estimate change ☑

- **Underperformance overdone** — Patni has underperformed the BSEIT index by ~35% over the past year (despite EPS upgrades). While business-related concerns persist, at 11.7x CY08E the stock is cheaper than most mid caps. This should protect downside, while M&A-related news flow could drive upside.

- **Expect a muted 1Q07** — We expect muted performance to continue – our estimates are 2.4% QoQ growth to $158m and 1.5% decline in net profits to $25.3m. Patni guided to revenues of $155m and net profit of $22.5-23m. Our primary concern has been sluggish top-line growth over the past few quarters.

- **Hiring not visible; Attrition alarming** — Patni added ~9% to its delivery manpower over the past year compared with 30-40% for its larger peers. Utilization in 4Q06 was 73.7%, closer to its larger peers. Attrition (LTM excluding BPO) rose to 27.4% last quarter, much higher than its larger peers.

- **Why upgrade?** — Patni has ~25% of market cap as cash. Valuations at 6.9x 2007 EV/EBITDA is at a ~48% discount to its larger peers like Satyam. Moreover, Patni is a decent size, making it a likely acquisition candidate. Any acquisition by Patni (with its large cash on books) could also be a trigger.

- **Outlook modest; valuations protect downside** — We believe that Patni's outlook remains modest – revenue growth should be slow and wage pressures continue. We are raising our estimates by 10% for CY07 and 4% for CY08 due to lower SG&A, higher other income and lower tax rates. We are raising our target price to Rs463 (based on 15x average of CY07 and CY08 earnings).

Buy/Medium Risk	1M
from Sell/Medium Risk	
Price (02 Apr 07)	Rs375.40
Target price	Rs463.00
from Rs405.00	
Expected share price return	23.3%
Expected dividend yield	0.9%
Expected total return	**24.3%**
Market Cap	Rs52,496M
	US$1,218M

Price Performance (RIC: PTNI.BO, BB: PATNI IN)

See Appendix A-1 for Analyst Certification and important disclosures.

Statistical Abstract

Year to 31 Dec	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	2,678	21.03	10.3	17.9	2.4	16.1	0.7
2006A	2,654	19.05	-9.4	19.7	2.3	12.4	0.8
2007E	4,126	29.60	55.4	12.7	2.0	17.0	0.9
2008E	4,486	32.19	8.7	11.7	1.7	16.1	1.3
2009E	5,275	37.85	17.6	9.9	1.5	16.5	1.3

Source: Powered by dataCentral

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Fiscal year end 31-Dec	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	17.9	19.7	12.7	11.7	9.9
EV/EBITDA adjusted (x)	11.3	8.3	6.9	6.0	4.8
P/BV (x)	2.4	2.3	2.0	1.7	1.5
Dividend yield (%)	0.7	0.8	0.9	1.3	1.3
Per Share Data (Rs)					
EPS adjusted	21.03	19.05	29.60	32.19	37.85
EPS reported	21.03	19.05	29.60	32.19	37.85
BVPS	159.71	162.36	188.22	214.99	247.46
DPS	2.50	3.00	3.50	5.00	5.00
Profit & Loss (RsM)					
Net sales	19,834	26,140	29,446	33,961	41,151
Operating expenses	-16,734	-22,205	-24,964	-29,150	-35,501
EBIT	**3,100**	**3,935**	**4,482**	**4,811**	**5,649**
Net interest expense	0	0	0	0	0
Non-operating/exceptionals	186	564	707	832	944
Pre-tax profit	**3,286**	**4,499**	**5,189**	**5,643**	**6,594**
Tax	-608	-932	-1,064	-1,157	-1,319
Extraord./Min.Int./Pref.div.	0	-913	0	0	0
Reported net income	**2,678**	**2,654**	**4,126**	**4,486**	**5,275**
Adjusted earnings	2,678	2,654	4,126	4,486	5,275
Adjusted EBITDA	3,770	4,775	5,545	5,986	7,057
Growth Rates (%)					
Sales	40.4	31.8	12.6	15.3	21.2
EBIT adjusted	17.8	26.9	13.9	7.3	17.4
EBITDA adjusted	20.7	26.7	16.1	7.9	17.9
EPS adjusted	10.3	-9.4	55.4	8.7	17.6
Cash Flow (RsM)					
Operating cash flow	**3,830**	**2,717**	**4,532**	**4,558**	**5,307**
Depreciation/amortization	670	840	1,063	1,175	1,408
Net working capital	865	-213	51	-271	-431
Investing cash flow	**-2,636**	**-2,370**	**-1,209**	**-1,886**	**-2,176**
Capital expenditure	-2,423	-2,251	-2,060	-2,718	-3,120
Acquisitions/disposals	-128	-456	0	0	0
Financing cash flow	**4,825**	**-639**	**-551**	**-788**	**-788**
Borrowings	2	-1	0	0	0
Dividends paid	-317	-473	-551	-788	-788
Change in cash	**6,019**	**-292**	**2,772**	**1,885**	**2,344**
Balance Sheet (RsM)					
Total assets	**24,815**	**28,232**	**32,945**	**37,705**	**43,882**
Cash & cash equivalent	13,062	12,770	15,542	17,427	19,770
Accounts receivable	0	0	0	0	0
Net fixed assets	4,136	5,547	6,544	8,086	9,798
Total liabilities	**4,397**	**5,797**	**6,937**	**7,998**	**9,688**
Accounts payable	0	0	0	0	0
Total Debt	19	17	17	17	17
Shareholders' funds	**20,418**	**22,434**	**26,008**	**29,707**	**34,194**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	19.0	18.3	18.8	17.6	17.1
ROE adjusted	16.1	12.4	17.0	16.1	16.5
ROIC adjusted	34.2	33.2	31.9	30.0	30.3
Net debt to equity	-63.9	-56.8	-59.7	-58.6	-57.8
Total debt to capital	0.1	0.1	0.1	0.1	0.1

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Patni – Reasonable valuations but lacking upside triggers

Figure 1. Patni – Earnings revision table

FYE 31 Dec	Net Profit (RsM)	EPS (Rs)	% chg	DPS (Rs)
2007E	4,126	29.60	10.3	3.50
Prev	3,858	26.83		3.00
2008E	4,486	32.19	4.2	5.00
Prev	4,441	30.89		5.00
2009E	5,275	37.85	na	5.00
Prev	na	na		na

Source: Company Reports and CIR Estimates

Recapping Q4CY06

4Q06 revenue disappointed again

4Q06 disappointed again with revenue growth of 1.7% QoQ in USD terms at $154.3m. Revenue guidance for 1QCY07 was muted at $155m, flat QoQ.

Cost rationalization saves the day

Good cost rationalization resulted in margin surprise – SG&A costs edged down 80bp QoQ (after a 260bp decline in 3Q). Operating margins improved by ~110bps primarily on account of SG&A savings, lower forex losses and some improvement in gross margins.

Attrition at alarming levels

Attrition (LTM excluding BPO) increased again to 27.4%, which is significantly higher than its larger peers.

Net addition still not inspiring

Patni added ~9% to its delivery manpower over the past year compared with 30-40% for its larger peers. Utilization now stands at 73.7%, in line with its larger peers.

No great expectations for 1QCY07

Revenue growth expectation of 2.4% QoQ

We expect 2.4% QoQ growth to $158m (against Patni's guidance of $155m. In terms of net profit, we expect $25.3m (against their guidance of $22.5-23.0m), which is a decline of ~1.5% sequentially.

How much more can Patni cut costs?

While we factor in ~20bps improvement in EBIT margins in 1QCY07, we believe that Patni is reaching an optimum level of cost management. SG&A costs are falling in line with peers, utilization witnessed a sharp improvement and we believe that incremental margin improvements from here on will be difficult to achieve without revenue growth accelerating.

Bullish arguments

Stock is cheap

Trading at 12.7x CY07 earnings and 6.9x CY07 EV/EBITDA, Patni is one of the cheapest stocks in the Indian IT Services sector.

Ideal take out candidate

With Satyam ruling itself out of contention, Patni remains the largest India listed acquisition candidate in our view. With M&A being an important theme in the sector, Patni will benefit from actual and rumored M&A news.

An acquisition can change things

Patni's growth accelerated in CY05 after it acquired Cymbal. With cash of ~$300m on its books, an acquisition is a possibility. However, at this point, it is difficult to factor this in.

Bearish arguments

Topline growth significantly lower than peers

Patni's growth trajectory has been significantly lower than peers over the past few years. Without Cymbal, its CY05 growth would have significantly lagged its peers. We continue to believe that the lack of a strong flagship practice (like Satyam's ERP), lower geographic diversification, higher dependence on ADM and mature clients (like GE) will continue to drive lower-than-industry growth rates.

Is Patni under-investing in the business?

Patni has been undergoing strong cost rationalization measures that have helped reduce SG&A from 20% in 1QCY07 to 16.3%in 4QCY07. Sales and marketing is at 7.4% of revenues, which for a much larger player like Infosys is at 6.4% of revenues. Moreover, with utilizations reaching optimal levels and SG&A costs getting aligned to rest of industry, it will be difficult for Patni to squeeze much cost efficiency going forward.

Valuations have largely been reflection of growth prospects in tech

Valuations in tech have largely been a function of growth. While 7x EV/EBITDA looks cheaper compared to the sector, we believe that Patni's improving growth prospects (organically or through acquisitions) or M&A are the two key triggers, which could act as a stock price driver going forward.

Figure 2. Patni – P/E valuation premium/(discount) to Satyam

Source: DataStream, Company Reports and CIR Estimates

Valuations to protect further downside

In 1Q07, Patni has guided to a flat quarter given the ramp down in a large telecom client. With impending wage hikes in 2Q, margins will be hit again.

We believe that relatively cheap valuations (6.9x CY07 EV/EBITDA) will protect from further downside.

While the business outlook remains modest, we think Patni remains an attractive acquisition target. Any acquisition by Patni (with the high cash on books) could also be an upside trigger.

We upgrade the stock to Buy/Medium Risk with a target price of Rs463 based on 15x (in-line with our earlier target multiple) average of CY07 and CY08 earnings.

Figure 3. Patni – P/E valuation band chart

Source: DataStream, Company Reports and Citigroup Investment research estimates; using recurring fully diluted EPS to calculate P/E

Figure 4. Indian IT services – Valuation comparison table

			Mkt cap	Share	Target	P/E (x)		EV/EBITDA (x)		P/BV (x)		Div. Yield (%)	
Company	RIC Code	Rating	(US$m)	price	price	FY07E	FY08E	FY07E	FY08E	FY07E	FY08E	FY07E	FY08E
Infosys	INFY.BO	1L	24,861	1,921	2,660	29.3	22.7	23.3	17.8	10.4	7.5	0.6%	0.8%
TCS	TCS.BO	1L	26,985	1,189	1,560	28.1	22.0	22.8	17.6	12.8	8.8	0.8%	1.0%
Wipro	WIPR.BO	1L	17,519	518	730	26.5	20.7	21.0	16.1	8.0	6.5	1.5%	1.9%
Satyam	SATY.BO	1M	6,884	446	582	21.9	17.7	17.1	13.4	5.5	4.5	1.3%	1.8%
HCL Tech	HCLT.BO	1M	4,150	272	385	17.8	14.9	12.7	10.1	3.9	3.4	2.9%	2.9%
Patni*	**PTNI.BO**	**1M**	**1,218**	**375**	**463**	**19.7**	**12.7**	**8.3**	**6.9**	**2.3**	**2.0**	**0.8%**	**0.9%**
I-Flex	IFLX.BO	3M	3,974	2,057	1,850	51.7	39.1	39.8	27.8	9.6	7.7	0.1%	0.1%
Hexaware*	HEXT.BO	1M	517	168	214	18.6	14.9	16.0	10.0	3.7	2.7	1.0%	1.2%
NIIT	NIIT.BO	1M	310	678	690	28.0	16.0	16.6	11.7	4.3	3.5	1.0%	1.1%
Sasken	SKCT.BO	1M	314	475	653	27.5	15.2	15.0	10.6	3.1	2.7	0.6%	1.1%
KPIT	KPIT.BO	1M	226	131	173	24.2	14.6	13.6	10.4	5.2	3.9	0.4%	0.4%

Source: Company Reports and Citigroup Investment research estimates; *Using CY06E and CY07E for these companies (31-Dec year-ending).

Revenue growth was muted during the quarter. However, continued cost take-outs have helped margins.

Figure 5. Patni – Key Financials

	4Q05	3Q06	4Q06	QoQ	YoY
Revenue (US$ m)	**124**	**152**	**154**	**1.7%**	**24.5%**
Revenue	**5,569**	**6,999**	**6,805**	**-2.8%**	**22.2%**
Cost of revenue	3,441	4,360	4,215	-3.3%	22.5%
Gross profit	2,129	2,639	2,590	-1.9%	21.7%
Gross margin	38.2%	37.7%	38.1%	0.9%	-0.4%
Operating expenses	1,128	1,278	1,149	-10.1%	1.9%
EBITDA	**1,001**	**1,361**	**1,441**	**5.9%**	**44.0%**
EBITDA margin	***18.0%***	***19.4%***	***21.2%***	**173bp**	**321bp**
Depreciation and amortization	189	203	239	17.5%	26.4%
EBIT	**812**	**1,158**	**1,202**	**3.8%**	**48.1%**
EBIT margin	***14.6%***	***16.5%***	***17.7%***	**112bp**	**309bp**
Other income	28	134	198	47.8%	614.3%
Profit before tax	840	1,292	1,400	8.4%	66.8%
Income tax expense	179	268	265	-0.9%	48.5%
Net income - recurring	661	1,024	1,135	10.8%	71.7%
EO income/(loss)	0	0	0	n.a.	n.a.
Net profit	661	1,024	1,135	10.8%	71.7%
EPS - basic (recurring)	5.17	7.43	8.21	10.6%	58.9%
EPS - fully diluted (recurring)	5.09	7.38	8.14	10.4%	60.0%

Source: Company Reports

Hiring was weak in CY06. Management focus has been to improve utilization.

Attrition has been increasing every quarter. Also, it has started reporting LTM attrition numbers against quarterly annualized earlier.

Figure 6. Patni – Key HR Metrics

	1Q06	2Q06	3Q06	4Q06
Total staff	12,148	12,608	12,428	12,804
- Offshore	9,594	9,908	9,648	10,009
- Onsite	2,554	2,700	2,780	2,795
- Delivery	10,951	11,343	11,150	11,553
- Sales and Support	1,197	1,265	1,278	1,251
Effort by location of delivery				
Offshore	66.3%	66.3%	66.1%	67.9%
Onsite	33.7%	33.7%	33.9%	32.1%
Other Key metrics				
Utilization (net of support, includes trainees)	67.8%	70.2%	72.3%	73.7%
Attrition Rate (Quarterly, annualized – ex BPO)	20.3%	21.0%	n.a.	n.a.
Attrition Rate (LTM – ex BPO)	n.a.	n.a.	24.5%	27.4%

Source: Company Reports

Figure 7. Patni – Key Client Metrics

	1Q06	2Q06	3Q06	4Q06
Client concentration				
Top Client - GE	16.5%	14.5%	14.1%	13.5%
Top 5 Clients	39.8%	38.1%	36.9%	38.0%
Top 10 Clients	55.3%	54.0%	51.6%	52.2%
Client relationship				
Total Active Clients	206	220	235	239
New Clients added	20	23	27	22
1+ mn USD Clients	61	64	71	74

Source: Company Reports

Exposure to North America is still very high – contributing over three quarters of revenue

ADM share, though declining gradually, is still higher than larger Indian IT companies

Figure 8. Patni – Revenue Mix Metrics

	1Q06	2Q06	3Q06	4Q06
Geography - wise				
North America	83.0%	81.0%	82.1%	77.7%
Europe	10.2%	11.2%	9.7%	15.1%
Japan	4.5%	3.9%	3.8%	3.0%
RoW	2.3%	3.9%	4.4%	4.2%
Service - wise				
ADM	71.7%	71.8%	69.8%	70.1%
Enterprise applications systems	11.6%	13.6%	14.2%	13.2%
Enterprise systems management	10.3%	9.0%	9.7%	9.1%
Embedded technology services	5.1%	4.0%	4.6%	4.7%
Others	1.3%	1.6%	1.8%	2.8%
SBU - wise				
Insurance	24.1%	23.2%	23.2%	22.5%
Manufacturing	20.3%	21.4%	22.5%	22.2%
Financial Services	15.8%	15.5%	15.6%	14.3%
Telecommunications	18.9%	20.0%	17.1%	19.4%
Other	6.8%	6.0%	6.9%	7.3%
ISV Practice	4.1%	4.2%	4.0%	4.2%
Product Engineering Practice	10.0%	9.7%	10.6%	10.2%

Source: Company Reports

Patni Computer Systems

Company description

Patni is the sixth-largest IT solutions provider from India and a pioneer of offshore IT services delivery. Founded in 1978, it operated both software and hardware businesses until 1999, when the hardware business was de-merged. It continued to operate as a global consulting and IT services provider. Patni employs 12,000 professionals, who service more than 200 global corporations. It has a sizeable presence in insurance, financial services, manufacturing and telecoms verticals. GE is Patni's largest customer, contributing close to 15% of CY06 revenues.

Investment thesis

We rate Patni Buy/Medium Risk. Patni has been facing increased wage pressure, which has eroded margins. However, over the past two quarters, cost optimization efforts have reversed this trend. Our investment thesis is primarily driven by valuation – Patni trades at 45% discount to Satyam's on one-year forward EV/EBITDA, has 25% of its market cap in cash and equivalents and has underperformed the BSE IT index by 35% over the past year. With high cash position of ~USD$300m, we believe Patni can aggressively acquire smaller companies overseas, which could change the growth trajectory and act as a trigger for the share price. Also, as a decent-sized player with a relatively inexpensive valuation, it would make an ideal acquisition candidate.

Valuation

Our target price is Rs463. We value Patni against closest peer Satyam and expect Patni's recurring earnings to grow by a 16% CAGR over the next three years (lower than peers). Patni has traded at a 10-40% discount to Satyam over the past year, mainly due to slower growth and lower RoIC/RoE. We believe that the stock will continue to trade at the high end of the discount range and our target price is based on 15x average of CY07-CY08 earnings, which is a 30% discount to our target P/E of 21x for Satyam. We believe that P/E is a good valuation measure given Patni's profitability and strong earnings visibility.

Risk

We rate Patni as Medium Risk based on our quantitative risk-rating system, which tracks 260-day historical share price volatility. The key upside risks that could take the stock above our target price include: 1) Any significant depreciation of the rupee against the USD/Euro/GBP; 2) A sharp pick-up in discretionary spend; 3) Patni being an acquisition target by a global IT services vendor; and 4) Patni acquiring a small-to-mid-sized company at attractive valuations. Key downside risks to our target price include: 1) Significant QoQ volatility in growth rates; 2) Any significant appreciation of the rupee against the USD/Euro/GBP; 3) A sharp slowdown in the US economy; 4) A slowdown in the banking, financial services and insurance (BFSI) sector; 5) H1B visa quotas; and 6) Acquisition-related risks.

Appendix A-1

Analyst Certification

We, Surendra Goyal, CFA and Hitesh Shah, research analysts and the authors of this report, hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

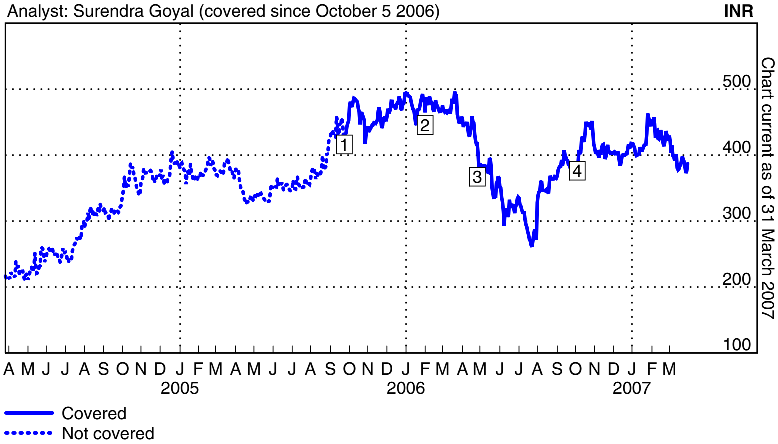
IMPORTANT DISCLOSURES

Patni Computer Systems (PTNI.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Surendra Goyal (covered since October 5 2006)

INR



#	Date	Rating	Target Price	Closing Price
1:	23 Sep 05	1M	510.00	416.05
2:	1 Feb 06	1M	*560.00	464.60
3:	26 Apr 06	1M	*500.00	416.70
4:	4 Oct 06	*3M	*405.00	381.95

*Indicates change.

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