SATYAM COMPUTER SERVICES

INR 148

Edelweiss
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All roads lead to Rome

SELL

December 29, 2008

As investors and potential acquirers ponder feasible courses of action on Satyam, we lay out for the convenience of investors our view on the likelihood of the following options and impact thereof:

(a) Board reconstituted but management remains

(b) A big-ticket private equity major/financial investor buys out collective stake of a clutch of major investors

(c) If an open offer is triggered, the deal or transaction may be even more unpalatable

(d) A global MNC (such as IBM/Cap Gemini) as a strategic investor

(e) Diminished stake of promoters is immaterial to situation at hand

(f) Finally, what about Upaid? How will potential financial/strategic investors view this?

Board reconstituted but management remains

This is purely cosmetic. In our view, investors will not be appeased with this course of action unless management is forced out (read: promoters and executive board members). After all, they could perceive the board (and some of the stalwarts in it) as ineffective but not dubious. It is now learnt that the management kept a tight lid on developments on the World Bank front and did not take the board into confidence on this. Hence, more than the board, we believe that management has come out worse from this episode. Thus, while the board is certain to get overhauled, the probability of management staying intact is low.

A big-ticket private equity major/financial investor buys out collective stake of a clutch of major investors

Again, this is unlikely to hold significance or yield much benefit unless the private equity major also imposes a change in the executive management. Why would a private equity major buy into a tarnished management? So, unless such a financial investor has the wherewithal to effect such a change, it is unclear how he can immediately take a stake in the company. Another possibility could be a temporary management reshuffle and appointment of an interim management team. However, much of this will depend on the ability of financial investors to find suitable replacement to Ramalinga Raju and his team. The sticking point may be in the offer price, which we have discussed further in this report.

Financials

Year to March	FY07	FY08	FY09E	FY10E
Revenues (INR mn)	64,851	84,735	113,709	122,868
Growth (%)	*35.3*	*30.7*	*34.2*	*8.1*
EBITDA (INR mn)	15,377	18,348	26,521	28,382
Growth (%)	31.9	19.3	44.5	7.0
Net profit (INR mn)	14,047	16,879	22,907	24,115
Growth (%)	23.0	20.2	35.7	5.3
Shares outstanding (mn)	667.2	670.5	674.0	674.0
Diluted EPS (INR)	20.8	24.7	33.3	35.0
EPS growth (%)	*22.1*	*18.7*	*35.0*	*5.0*
Diluted P/E (x)	7.1	6.0	4.4	4.2
EV/EBITDA (x)	4.0	3.1	1.3	0.6
ROAE (%)	27.9	26.0	27.6	23.2

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Reuters	:	SATY.BO
Bloomberg	:	SCS IN

Market Data

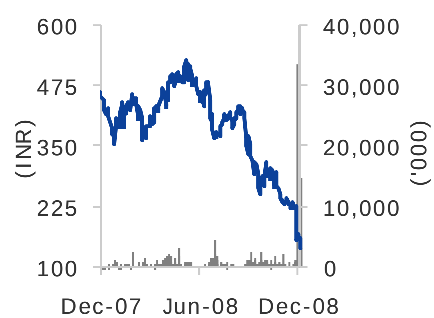
52-week range (INR)	:	544 / 153
Share in issue (mn)	:	673.5
M cap (INR bn/USD mn)	:	99.6/2,059.4
Avg. Daily Vol. BSE ('000)	:	5,186.4

Share Holding Pattern (%)

Promoters	:	8.6
MFs, FIs & Banks	:	14.7
FIIs	:	46.9
Others	:	29.8

Relative Performance (%)

	Sensex	Stock	Stock over Sensex
1 month	8.8	(38.9)	(47.7)
3 months	(29.3)	(58.0)	(28.7)
12 months	(51.2)	(69.1)	(17.9)



If an open offer is triggered, the deal or transaction may be even more unpalatable

An open offer for an additional 20% stake is triggered if the stake proposed to be acquired in the first instance is at least 15%. The open offer price as per the SEBI pricing formula is the higher of the 6-month average (INR 330 per share) and the two-week average (INR 176). At INR 330, it represents well over a 100% premium to the current market price. That is a tough sell for the existing investors to a financial investor. **For this reason, we see the likelihood of a less than 15% stake sale accompanied by management change as the most probable option.**

A global MNC (such as IBM/Cap Gemini) as a strategic investor

While this could be the most palatable option, it is also a difficult one. It is palatable because not only could an MNC exploit synergies and advantages of cost-arbitrage, but also it is best placed to replace the Satyam management and provide new leadership. However, the disadvantage of minimum open offer price of INR 330 may still hold. The name of Cap Gemini is doing the rounds. However, the balance sheet of Cap Gemini is somewhat constrained (net cash of USD 1.3 bn or EUR 0.9 bn) and its cash flow generating capacity low (free cash flows before acquisitions is just 4% of revenues). Also, Cap Gemini, in a significant acquisition, acquired Kanbay (an Indian offshore services firm) for EUR 954 mn in CY07 (cash outflows from the Kanbay acquisition in 2007 amounted to EUR 900 mn, while goodwill for the acquisition was EUR 830 mn). **Would Cap Gemini really want to absorb one more, having already planted its stake in the offshore services territory ?**

Despite all this, even if Cap Gemini were still a willing suitor, it may able to assume a minority stake only in Satyam (~20-25% at the most) at the SEBI-prescribed floor price. The question really is whether that is a strong enough incentive in an environment like this. Thus, IBM, a name bandied about so often in the past, still seems the most likely horse needed to ride out Satyam and its management.

Table 1: Most giant European system integrators lack the balance sheet liquidity and strength to fund decent-sized acquisitions

	Logica CMG (mn £)			Capgemini (mn €)			Atos Origin (mn €)			TietoEnator (mn €)		
	2007	**2006**	**2005**	**2007**	**2006**	**2005**	**2007**	**2006**	**2005**	**2007**	**2006**	**2005**
Revenue	3,073	2,420	1,834	8,703	7,700	6,954	5,855	5,397	5,459	1,772	1,647	1,570
% CAGR (05-07)	*29.4*			*11.9*			*3.6*			*6.2*		
Operating income	133	166	121	493	334	214	271	247	399	1	128	169
% of revenue	4.3	6.9	6.6	5.7	4.3	3.1	4.6	4.6	7.3	0.1	7.8	10.8
% CAGR (05-07)	*(18.9)*			*35.7*			*(20.4)*			*(91.7)*		
Net income	168	89	83	440	293	141	63	(248)	246	(32)	247	138
% of revenue	5.5	3.7	4.5	5.1	3.8	2.0	1.1	(4.6)	4.5	(1.8)	15.0	8.8
% CAGR (05-07)	*26.5*			*46.1*			*(36.5)*			*(161.6)*		
Long-term debt	274	499	118	1,059	1,160	1,145	444	589	506	172	200	106
Cash	108	177	245	648	442	416	348	453	534	73	139	100
Net cash	**(166)**	**(322)**	**127**	**(411)**	**(718)**	**(729)**	**(96)**	**(136)**	**28**	**(99)**	**(61)**	**(6)**
Networth	**1,597**	**1,525**	**819**	**3,851**	**3,697**	**2,750**	**1,692**	**1,675**	**1,873**	**474**	**622**	**489**
Mkt cap (mn)	**1,059**	**mn £**		**3,836**	**mn €**		**1,200**	**mn €**		**555**	**mn €**	

Source: Company, Edelweiss research

Diminished stake of promoters is immaterial to situation at hand

Reports have emanated about a dilution of the promoters' stake in Satyam (on account of selling by financial institutions of the shares pledged by them by promoters). This is immaterial in our view, since what is really at stake and an issue is not promoters' holding or its dilution but control of the company by the current management. To the limited extent that dilution of promoter interest weakens the case of the current management to stay on, investors would be pleased.

Finally, what about Upaid? How will potential financial/strategic investors view this?

All potential financial/strategic investors are likely to weigh consequences of the Upaid dispute with utmost deliberation (indeed, they would study all of Satyam's liabilities and pending cases against it in full awareness). Upaid demands about USD 1 bn in damages, and if it is felt that the advantage in this suit lies with Upaid, that could be a big disincentive for an incoming investor in Satyam. An out-of-court settlement as a precursor to a transaction in Satyam with Upaid may be necessary, as nobody would want to be saddled with an albatross round the neck.

A precedent for corporate governance arbitrage

What this sorry episode has done is leave a huge hole in corporate governance at Satyam that is there to be almost instantly exploited. If shareholders manage to keel over the management, there is an immediate P/E lift. In this context, we recollect what Barings Private Equity Partners (Barings), an influential holder in BFL Software, did by merging Mphasis into BFL in 2001; it hired Jerry Rao and a host of heavy-weights from Citibank to head and manage MphasiS and also got rid of the management of BFL Software, who did not enjoy a great reputation with investors. They, then, merged BFL into MphasiS, making Jerry Rao and his team the managing entity. In doing so, Barings invested BFL with instant credibility and assured its investors. That one action and subsequent institution of a corporate governance framework sent the BFL scrip soaring 140% in three months' time (during 2001). The P/E arbitrage for corporate governance was immediately exploited. Such exploitation in Satyam is perhaps possible by simply seeking to replace the management. There is sizable gain for shareholders when an influential entity or body of entities moves in that direction. **Raiders are surely on the prowl.**

Conclusion: All roads lead to Rome

Satyam management's continuance seems to be untenable regardless of the new board composition. This possibility alone is likely to exploit the corporate governance arbitrage that we mentioned. The roads to this desired outcome, from the perspective of Satyam's existing investors, are laced with hurdles that do not seem to have an easy or immediate solution (SEBI floor price in case of acquisition of stake exceeding 15%, Upaid and other liabilities, sharper customer contract due diligence in the wake of World Bank mess-up, management shake-up are some issues that we can identify at this stage). Whatever emerges is likely to be drawn-out. In the evolving scheme of considerations, we believe that a buy-back is relatively peripheral.

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 and financial services, insurance, telecom-infrastructure-media-entertainment-semiconductors (TIMES), and healthcare, among others. Satyam has the largest ERP practice amongst offshore vendors, with competencies in implementation of enterprise packages such as Oracle, SAP, PeopleSoft, and JD Edwards. Satyam's presence spans 55 countries, across six continents. The company has 649 clients across the globe (including subsidiaries) and employs over 52,865 professionals, including its subsidiaries and joint ventures. Revenues for FY08 stood at INR 84.7 bn and profits at INR 16.9 bn, up 30% and 20% respectively from that in FY07.

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. The company has recognised the need to focus on large deals and formed a strategic deals group (SDG) to pursue and filter large deal opportunities. We believe that Satyam's strong revenue momentum and lower BFSI exposure, compared with peers, puts it in a relatively good position in the event of weakness in this space.

Key Risks

Key risks to our investment theme include: (a) Slowdown in the US IT spending; (b) supply side constraints such as salary hikes and attrition; and (c) appreciation of the rupee against the dollar.

Financial Statements

Income statement (INR mn)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Revenues	47,926	64,851	84,735	113,709	122,868
Cost of revenues	28,044	38,579	52,595	68,475	72,830
Gross profit	19,882	26,272	32,140	45,234	50,038
Total SG&A expenses	8,220	10,894	13,792	18,713	21,656
EBITDA	11,662	15,377	18,348	26,521	28,382
Depreciation & Amortization	1,373	1,484	1,636	2,417	2,703
EBIT	10,289	13,893	16,712	24,105	25,679
Interest expense	55	159	201	190	0
Other income	3,333	1,833	2,671	2,027	2,200
Profit before tax	13,565	15,566	19,182	25,942	27,879
Tax	2,075	1,520	2,304	3,033	3,764
Core profit	11,490	14,046	16,879	22,909	24,115
Profit after tax	11,490	14,046	16,879	22,909	24,115
Minority int. and others - paid/(recd.)	73	(1)	-	2	-
Net profit after minority interest	11,417	14,047	16,879	22,907	24,115
Shares outstanding (mn)	644	667	671	674	674
EPS (INR) basic	17.7	21.1	25.2	34.0	35.8
Diluted shares (mn)	670	675	683	687	689
EPS (INR) diluted	17.1	20.8	24.7	33.3	35.0
CEPS (INR)	19.9	23.3	27.6	37.6	39.8
Dividend per share	3.5	6.9	4.0	4.0	6.0
Dividend (%)	349.4	343.8	197.6	197.9	297.6
Dividend pay out (%)	19.9	32.7	15.7	11.6	16.6

Common size metrics - as % of revenues

Year to March	FY06	FY07	FY08	FY09E	FY10E
Cost of revenues	58.5	59.5	62.1	60.2	59.3
Gross margin	41.5	40.5	37.9	39.8	40.7
SG&A expenses	17.2	16.8	16.3	16.5	17.6
EBITDA margin	24.3	23.7	21.7	23.3	23.1
EBIT margin	21.5	21.4	19.7	21.2	20.9
Net profit margins	24.0	21.7	19.9	20.1	19.6

Growth metrics (%)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Revenues	36.1	35.3	30.7	34.2	8.1
EBITDA	34.3	31.9	19.3	44.5	7.0
EBIT	36.3	35.0	20.3	44.2	6.5
PBT	61.8	14.8	23.2	35.2	7.5
Net profit	59.3	22.2	20.2	35.7	5.3
EPS	55.5	22.1	18.7	35.0	5.0

Balance sheet (INR mn)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Equity share capital	1,577	1,868	1,359	1,348	1,348
Share premium account	10,286	13,212	13,577	15,079	16,580
Reserves	31,309	42,446	57,456	77,242	96,663
Total shareholders funds	43,172	57,526	72,392	93,668	114,591
Borrowings	1,027	1,479	2,167	351	350
Sources of funds	**44,241**	**59,005**	**74,559**	**94,021**	**114,943**
Goodwill and other intangible asset	938	938	938	938	938
Gross fixed assets	12,234	14,117	18,664	24,102	29,439
Less: Accumulated depreciation	8,402	9,848	11,417	13,834	16,537
Net fixed assets	3,832	4,269	7,247	10,268	12,902
Capital WIP	803	3,017	4,610	450	451
Investments	2	-	-	750	750
Deferred tax asset	46	437	872	176	176
Cash & bank balances	31,117	39,914	45,024	66,059	83,142
Debtors	11,684	17,432	23,703	25,546	27,603
Loans and advances	2,949	2,945	6,644	6,011	6,358
Total current assets	45,750	60,292	75,372	97,616	117,103
Sundry creditors	4,370	5,745	8,977	10,177	11,377
Provisions	2,760	4,201	5,502	6,000	6,000
Total current liabilities	7,130	9,947	14,480	16,177	17,377
Working capital	38,621	50,345	60,893	81,439	99,726
Application of funds	**44,241**	**59,005**	**74,559**	**94,021**	**114,943**
Book value per share (BV) (INR)	67	86	108	139	170

Free cash flow

Year to March	FY06	FY07	FY08	FY09E	FY10E
Net profit	11,417	14,047	16,879	22,907	24,115
Depreciation	1,373	1,484	1,636	2,417	2,703
Others	(2,712)	(1,558)	(1,271)	698	0
Gross cash flow	10,078	13,974	17,244	26,022	26,818
Less:Changes In working capital	2,605	4,078	4,159	(489)	1,204
Operating cash flow	7,473	9,896	13,085	26,510	25,615
Less: Capex	2,446	3,827	3,572	1,278	5,339
Free cash flow	**5,027**	**6,069**	**9,513**	**25,232**	**20,276**

Cash flow statement (INR mn)

Year to March	FY06	FY07	FY08	FY09E	FY10E
Cash flow from operations	10,078	13,974	17,244	26,022	26,818
Cash for working capital	(2,605)	(4,078)	(4,159)	489	(1,204)
Operating cashflow (A)	7,473	9,896	13,085	26,510	25,615
Net purchase of fixed assets	(2,446)	(3,827)	(3,572)	(1,278)	(5,339)
Net purchase of investments	-	(15,129)	-	(750)	-
Others	301	2,130	631	-	-
Investments cashflow (B)	(451)	(17,088)	(5,387)	(2,028)	(5,339)
Dividends	(1,838)	(2,611)	(2,738)	(3,121)	(4,694)
Proceeds from issue of equity	1,399	3,016	(115)	1,490	1,501
Proceeds from LTB/STB	838	452	681	(1,816)	(1)
Financing cash flow (C)	343	702	(2,368)	(3,636)	(3,193)
Exchange rate differences (D)	12	92	(421)	-	-
Change in cash (A+B+C) + (D)	**7,378**	**(6,398)**	**4,909**	**20,846**	**17,083**

Ratios

Year to March	FY06	FY07	FY08	FY09E	FY10E
ROAE (%)	30.0	27.9	26.0	27.6	23.2
ROACE (%)	13.4	13.5	12.5	14.4	12.4
Debtors (days)	74	82	89	79	79
Payable (days)	26	28	32	31	32
Cash conversion cycle	48	53	57	48	47
Current ratio	6.4	6.1	5.2	6.0	6.7
Fixed assets turnover (x)	14.2	16.0	14.7	13.0	10.6
Total asset turnover(x)	0.3	0.3	0.3	0.3	0.3
Equity turnover(x)	1.3	1.3	1.3	1.4	1.2

Valuation parameters

Year to March	FY06	FY07	FY08	FY09E	FY10E
Diluted EPS (INR)	17.1	20.8	24.7	33.3	35.0
Y-o-Y growth (%)	*55.5*	*22.1*	*18.7*	*35.0*	*5.0*
CEPS (INR)	19.9	23.3	27.6	37.6	39.8
Diluted P/E (x)	8.7	7.1	6.0	4.4	4.2
Price/BV(x)	2.2	1.7	1.4	1.1	0.9
EV/Revenues (x)	1.3	0.9	0.6	0.3	0.1
EV/EBITDA (x)	5.5	3.8	3.0	1.2	0.6
EV/EBITDA (x)+1 yr forward	4.2	3.2	2.0	1.2	
Dividend yield %	2.4	4.6	2.7	2.7	4.0

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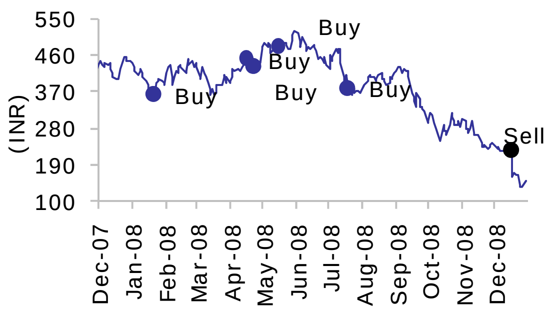
Coverage group(s) of stocks by primary analyst(s): Information Technology

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

Satyam



Recent Research

Date	Company	Title	Price (INR)	Recos
22-Dec-08	**Accenture**	Is the IDC overhyped? *Company Update*	USD 32	
16-Dec-08	**Satyam Computers**	Proposed acquisitions plumb new lows in corporate governance; *Event Update*	227	Sell
10-Dec-08	**Infosys Technologies**	The leaders will pull away in a zero-sum game; *Visit Note*	1,174	Accum.
26-Nov-08	**Infosys Technologies**	Rising premium reflects expectations of resilience; *Company Update*	1,187	Accum.

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Accumulate	Reduce	Sell	Total
Rating Distribution*	94	59	14	8	187

* 10 stocks under review / 1 rating withheld

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	75	65	47

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