

Margins surprise

Operating margins surprise

Patni reported a robust Q3 with in line revenue at Rs6.97bn, up 6% qoq and 34% yoy and huge margin out performance. EBIT margin ex forex was 330bps ahead of MLe. PAT was Rs1.02bn, up34% qoq and 44% yoy vs MLe at Rs0.84bn.

Utilization, G&A drive margin surprise

Utilization improved 300bps qoq to 72.3% and G&A costs came down from 12% of revenue last quarter to 10% this quarter. Management believes these levels of utilization and G&A are sustainable.

Muted guidance for Dec-06 quarter

Patni guided for flat revenue (USD152mn) and a slight PAT decline (USD 20.5mn) in Q4. Flat revenue guidance is due to a) fewer working days in Q4, b) couple of client specific issues (in telecom and financial services) and c) high exposure to manufacturing that has a slow Dec quarter. The PAT guidance takes into account a) US\$0.4mn ESOP charge, b) US\$0.4mn higher depreciation as Airoli campus gets commissioned and c) US\$0.7mn negative impact due to Rupee appreciation. We believe these should get absorbed going forward.

Increasing attrition, telecom vertical growth- key concerns

Attrition jumped this quarter by 3.5% to 24.5%. Telecom as % of total revenue was down by 3% (17.1% this qtr vs 20.2% last qtr). We believe company is facing growth issues in a top ten telecom client post M&A activity by the client.

Maintain Buy

We maintain our Buy on the stock. On our current numbers, Patni is trading at 17xCY07, a discount of ~10% to Satyam. We see an upside risk to our numbers.

Estimates (Dec)

(Rs)	2004A	2005A	2006E	2007E	2008E
Net Income (Adjusted - mn)	2,440.2	2,680.1	3,099.9	4,013.8	5,000.6
EPS	19.67	20.65	21.68	27.25	32.96
EPS Change (YoY)	8.3%	5.0%	5.0%	25.7%	21.0%
Dividend / Share	2.00	2.50	3.00	4.00	5.00
Free Cash Flow / Share	2.0	7.9	(5.1)	2.4	15.3
ADR EPS (US\$)	0.90	0.92	0.96	1.20	1.46
ADR Dividend / Share (US\$)	0.09	0.11	0.13	0.18	0.22

Valuation (Dec)

	2004A	2005A	2006E	2007E	2008E
P/E	23.0x	21.9x	20.8x	16.6x	13.7x
Dividend Yield	0.4%	0.6%	0.7%	0.9%	1.1%
EV / EBITDA*	15.7x	13.4x	11.7x	8.6x	6.8x
Free Cash Flow Yield*	0.4%	1.6%	-1.1%	0.5%	3.4%

* For full definitions of *iQmethod*SM measures, see page 7.



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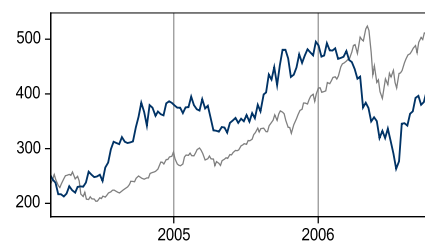
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Stock Data

Price (Common / ADR)	Rs451.85 / US\$21.11
Price Objective	Rs470.00 / US\$23.00
Date Established	20-Sep-2006 / 20-Sep-2006
Investment Opinion	C-1-7 / C-1-7
Volatility Risk	HIGH / HIGH
52-Week Range	Rs251.00-Rs508.00
Market Value (mn)	US\$1,379
Shares Outstanding (mn)	137.9 / 69.0
Average Daily Volume	88,906
ML Symbol / Exchange	PATIF / BSE
ML Symbol / Exchange	PTI / NYS
Bloomberg / Reuters	PATNI IN / PTNI.BO
ROE (2006E)	14.3%
Net Dbt to Eqty (Dec-2005A)	-63.9%
Est. 5-Yr EPS / DPS Growth	15.0% / 15.0%
Free Float	34.8%



- Patni - Bombay S.E. National Index

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Refer to important disclosures on page 7 to 9. Analyst Certification on page 6. Price Objective Basis/Risk on page 6.

iQprofileSM Patni Computer Systems

Key Income Statement Data (Dec)	2004A	2005A	2006E	2007E	2008E
(Rs Millions)					
Sales	14,573	19,829	26,296	32,610	38,866
Gross Profit	5,941	7,585	9,484	11,851	14,294
Sell General & Admin Expense	(2,605)	(3,746)	(5,084)	(5,944)	(6,840)
Operating Profit	2,715	3,101	3,530	4,730	5,988
Net Interest & Other Income	69	187	446	416	423
Associates	NA	NA	NA	NA	NA
Pretax Income	2,784	3,288	3,976	5,146	6,411
Tax (expense) / Benefit	(343)	(608)	(876)	(1,132)	(1,410)
Net Income (Adjusted)	2,440	2,680	3,100	4,014	5,001
Average Fully Diluted Shares Outstanding	124	130	143	147	152

Key Cash Flow Statement Data

Net Income (Reported)	2,440	2,680	3,100	4,014	5,001
Depreciation & Amortization	506	670	802	1,151	1,440
Change in Working Capital	(1,580)	(786)	(759)	(1,686)	(1,872)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	1,476	793	(32)	919	1,007
Cash Flow from Operations	2,843	3,357	3,111	4,397	5,575
Capital Expenditure	(2,597)	(2,353)	(3,815)	(4,072)	(3,460)
(Acquisition) / Disposal of Investments	NA	NA	NA	NA	NA
Other Cash Inflow / (Outflow)	NA	NA	NA	NA	NA
Cash Flow from Investing	(2,597)	(2,353)	(3,815)	(4,072)	(3,460)
Shares Issue / (Repurchase)	2,927	4,940	0	0	0
Cost of Dividends Paid	(246)	(319)	(414)	(552)	(690)
Cash Flow from Financing	2,680	4,621	(414)	(552)	(689)
Free Cash Flow	246	1,004	(704)	325	2,115
Net Debt	(7,057)	(12,789)	(12,073)	(11,599)	(12,647)
Change in Net Debt	(2,926)	(5,625)	1,117	226	(1,425)

Key Balance Sheet Data

Property, Plant & Equipment	2,394	4,055	6,562	8,845	10,574
Other Non-Current Assets	2,012	2,093	2,951	3,524	3,571
Trade Receivables	3,129	3,280	4,705	5,781	6,900
Cash & Equivalents	7,074	12,807	12,096	11,622	12,669
Other Current Assets	1,380	2,095	1,448	1,779	2,123
Total Assets	15,989	24,330	27,761	31,550	35,837
Long-Term Debt	NA	NA	NA	NA	NA
Other Non-Current Liabilities	1,284	490	464	472	466
Short-Term Debt	0	0	0	0	0
Other Current Liabilities	2,152	3,802	3,917	4,734	5,577
Total Liabilities	3,454	4,311	4,404	5,228	6,064
Total Equity	12,535	20,019	23,357	26,322	29,773
Total Equity & Liabilities	15,989	24,330	27,761	31,550	35,837

iQmethodSM - Bus Performance*

Return On Capital Employed	23.0%	15.6%	14.0%	15.8%	17.5%
Return On Equity	23.9%	16.5%	14.3%	16.2%	17.8%
Operating Margin	18.6%	15.6%	13.4%	14.5%	15.4%
EBITDA Margin	22.1%	19.0%	16.5%	18.0%	19.1%

iQmethodSM - Quality of Earnings*

Cash Realization Ratio	1.2x	1.3x	1.0x	1.1x	1.1x
Asset Replacement Ratio	5.1x	3.5x	4.8x	3.5x	2.4x
Tax Rate (Reported)	12.3%	18.5%	22.0%	22.0%	22.0%
Net Debt-to-Equity Ratio	-56.3%	-63.9%	-51.7%	-44.1%	-42.5%
Interest Cover	NM	NM	NA	NA	NA

Key Metrics

Sales Growth (YoY)	24.5%	36.1%	32.6%	24.0%	19.2%
EBITDA Growth (YOY)%	22.6%	17.1%	14.9%	35.7%	26.3%
EBIT Growth (YoY)	23.1%	14.2%	13.8%	34.0%	26.6%
Net Income Growth (%)	20.6%	9.8%	15.7%	29.5%	24.6%

* For full definitions of iQmethodSM measures, see page 7.

Company Description

Patni, India's 6th-largest IT services exporter (2005 revenues: US\$450.3mn, 11,802 people), is GE's 2nd-largest offshore vendor (US\$100mn client). Key strengths: Reasonable scale, domain focus, ability to manage large clients, & quality delivery. A dominant player in insurance & a meaningful player in financial services & banking, telecom services, and manufacturing. Key market is US. It is focusing on broadening its client and revenue base.

Stock Data

Shares / ADR	2.00
Price to Book Value	2.7x

Financials

Table 1: Quarter results

<i>USD '0000</i>	Jun 06		QoQ	Sep-05	YoY	MLe	Variation
	Sep 06	Recurring					
Revenue	151,707	143,027	6.1%	118,277	28.3%	150,028	1.1%
Cost of revenue	94,526	93,220	1.4%	74,751	26.5%	96,011	-1.5%
Gross Profit	57,181	49,807	14.8%	43,526	31.4%	54,016	5.9%
Sales and Marketing expenses	11,037	11,024	0.1%	9,576	15.3%	12,002	-8.0%
	7.3%	7.7%		8.1%		8.0%	
General and Admn. Expenses	16,185	18,386	-12.0%	13,711	18.0%	17,168	-5.7%
	10.7%	12.9%		11.6%		11.4%	
Provision for doubtful debt	520	161	223.0%	195	166.7%	150	246.7%
Depreciation	3,091	3,190	-3.1%	2,771	11.5%	3,612	-14.4%
Forex (gain)/ loss	1,262	(98)	nm	(542)	nm	-	nm
EBIT	25,086	17,144	46.3%	17,815	40.8%	21,084	19.0%
EBIT ex forex	26,348	17,046	54.6%	17,273	52.5%	21,084	25.0%
Other Income	2,946	4,000	-26.4%	1,563	88.5%	2,312	27.4%
PBT	28,032	21,144	32.6%	19,378	44.7%	23,396	19.8%
Income Taxes	5,751	4,450	29.2%	3,138	83.3%	5,147	11.7%
PAT	22,281	16,694	33.5%	16,240	37.2%	18,249	22.1%
Margins							
EBIT	16.5%	12.0%	455 bps	15.1%	147 bps	14.1%	248 bps
EBIT ex forex	17.4%	11.9%	545 bps	14.6%	276 bps	14.1%	331 bps
PAT	14.7%	11.7%	301 bps	13.7%	96 bps	12.2%	252 bps

INR/USD	45.95	45.87	0.2%	43.94	4.6%	45.9	0.1%
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<i>Rs million</i>	Jun 06		QoQ	Sep-05	YoY	MLe	Variation
	Sep 06	Recurring					
Revenue	6,971	6,561	6.3%	5,197	34.1%	6,887	1.2%
Cost of revenue	4,343	4,276	1.6%	3,285	32.2%	4,407	-1.4%
Gross Profit	2,627	2,285	15.0%	1,913	37.4%	2,479	6.0%
Sales and Marketing expenses	507	506	0.3%	421	20.5%	551	-7.9%
General and Admn. Expenses	744	843	-11.8%	602	23.4%	788	-5.6%
Provision for doubtful debt	24	7	223.5%	9	178.9%	7	247.0%
	142	146	-2.9%	122	16.7%	166	-14.3%
Forex (gain)/ loss	58	(4)	nm	(24)	nm	-	nm
EBIT	1,153	786	46.6%	783	47.3%	968	19.1%
EBIT ex forex	1,211	782	54.8%	759	59.5%	968	25.1%
Other Income	135	183	-26.2%	69	97.1%	106	27.6%
PBT	1,288	970	32.8%	851	51.3%	1,074	19.9%
Income Taxes	264	204	29.5%	138	91.7%	236	11.9%
PAT	1,024	766	33.7%	714	43.5%	838	22.2%
Margins							
EBIT	16.5%	12.0%	455 bps	15.1%	147 bps	14.1%	248 bps
EBIT ex forex	17.4%	11.9%	545 bps	14.6%	276 bps	14.1%	331 bps
PAT	14.7%	11.7%	301 bps	13.7%	96 bps	12.2%	252 bps

Source: Company, Merrill Lynch Research

Table 2: Consolidated Statement of Income

USD '000	CY2004	CY2005	CY2006E	CY2007E	CY2008
Revenues	326,582	450,332	580,887	728,803	898,731
Cost of revenues	193,438	278,068	371,384	463,932	568,209
Gross Profit	133,144	172,264	209,503	264,870	330,523
<i>S&M</i>	<i>23,177</i>	<i>36,062</i>	<i>45,698</i>	<i>58,304</i>	<i>70,101</i>
<i>G&A</i>	<i>35,211</i>	<i>49,019</i>	<i>66,604</i>	<i>74,546</i>	<i>88,076</i>
S,G&A Total	58,388	85,081	112,303	132,850	158,177
Provision for doubtful debts & advances	498	(152)	596	600	600
Forex (gain)/loss, net	2,082	1,693	896	-	-
EBITDA	72,176	85,642	95,709	131,420	171,746
Depreciation	11,333	15,213	17,723	25,714	33,289
EBIT	60,843	70,429	77,986	105,706	138,457
IPO related expense	(1,021)	-	-	-	-
Other Income (Expense), net	2,558	4,240	9,850	9,300	9,789
Income before income taxes	62,379	74,669	87,836	115,006	148,245
Income taxes	7,695	13,803	19,360	25,301	32,614
Net Income	54,684	60,867	68,476	89,705	115,631

Source: Company, Merrill Lynch Research

Table 3: Consolidated Balance Sheet

USD '000	CY2004	CY2005	CY2006E	CY2007E	CY2008E
Assets					
Cash and Cash Equivalents	162,766	290,596	265,966	260,909	293,869
Accounts Receivable	72,005	74,421	103,446	129,787	160,048
Other Current Assets	31,760	47,531	31,829	39,934	49,246
Property, Plant, and Equipment, net	55,075	92,010	144,287	198,572	245,283
Goodwill	24,678	27,987	41,987	52,987	52,987
Intangible Assets, Net	11,988	10,158	10,158	10,158	10,158
Other Assets	9,622	9,349	12,732	15,974	19,698
Total	367,893	552,051	610,404	708,322	831,289
Liabilities					
Total Current Liabilities	49,523	86,276	86,136	106,276	129,356
Other Long Term Liabilities	29,941	11,544	10,700	11,100	11,300
Net Worth	288,429	454,231	513,568	590,945	690,633
Total	367,893	552,051	610,404	708,322	831,289

Source: Company, Merrill Lynch Research

Table 4: Cash Flow Statement

USD '000	CY2004	CY2005	CY2006E	CY2007E	CY2008E
Cash Flow from Operating Activities					
Profit before tax	62,379	74,669	87,836	115,006	148,245
Depreciation and amortization	11,333	15,213	17,723	25,714	33,289
Change in current assets and liabilities					
Sundry Debtors and others	(35,399)	(17,914)	(16,706)	(37,688)	(43,297)
Current liabilities and provisions	33,088	18,355	(984)	20,540	23,280
Income taxes paid during the years	(7,695)	(13,803)	(19,360)	(25,301)	(32,614)
Net cash generated by operating activities	63,707	76,521	68,509	98,271	128,904
Cash Flows from Investing Activities					
Purchase of fixed assets and change in capital work in progress	(24,902)	(52,148)	(70,000)	(80,000)	(80,000)
Acquisition - Change in Goodwill	(33,291)	(1,480)	(14,000)	(11,000)	-
Net Cash used in investing activities	(58,193)	(53,628)	(84,000)	(91,000)	(80,000)
Free Cash Flow From Operating Activities	5,514	22,894	(15,491)	7,271	48,904
Cash Flows from Financing Activities					
Change in Share Capital	65,584	112,187	(0)	(0)	0
Dividend Paid including Dividend Tax	(5,516)	(7,251)	(9,139)	(12,328)	(15,944)
Net Cash used in financing activities	60,068	104,936	(9,139)	(12,328)	(15,944)
Net (decrease)/ increase in cash & cash equivalents	65,582	127,829	(24,630)	(5,056)	32,960
Cash & cash equivalents in the beginning of the year	97,184	162,766	290,595	265,966	260,909
Cash & cash equivalents at the end of the year	162,766	290,595	265,966	260,909	293,869

Source: Company, Merrill Lynch Research

Table 5: Key Ratios

	CY2004	CY2005	CY2006E	CY2007	CY2008
Gross Margin %	40.8%	38.3%	36.1%	36.3%	36.8%
EBITDA Margin %	22.1%	19.0%	16.5%	18.0%	19.1%
EBIT Margin %	18.6%	15.6%	13.4%	14.5%	15.4%
EBIT Margin (without forex related gains/losses) %	19.3%	16.0%	13.6%	14.5%	15.4%
PBT %	19.1%	16.6%	15.1%	15.8%	16.5%
PAT %	16.7%	13.5%	11.8%	12.3%	12.9%
Receivables days	80	60	65	65	65
S&M as % of Sales	7.1%	8.0%	7.9%	8.0%	7.8%
G&A as % of Sales	10.8%	10.9%	11.5%	10.2%	9.8%
SG&A as % of Sales	18%	19%	19%	18%	17.6%

Source: Company, Merrill Lynch Research

Price Objective Basis & Risk

Our local PO of Rs470 is based on 16x basic CY07E EPS (and 17x diluted CY07E EPS), lower than its current CY06E PE at 17x and at a reasonable 20% PE discount to closest peer, Satyam. Our ADR PO of US\$23 is at nearly 10% premium to local, in line with our target for peers.

Key company-specific risks are high revenue concentration from the US and higher attrition than peers (24.5% versus 11-19% for peers). Industry-wide risks are growing competition both from Indian vendors and global vendors ramping up in India, Rupee appreciation and risk of US slowing down.

Analyst Certification

I, Mitali Ghosh, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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iQmethodSM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) * (1 - Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price * Current Shares + Minority Equity + Net Debt + Other LT Liabilities	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

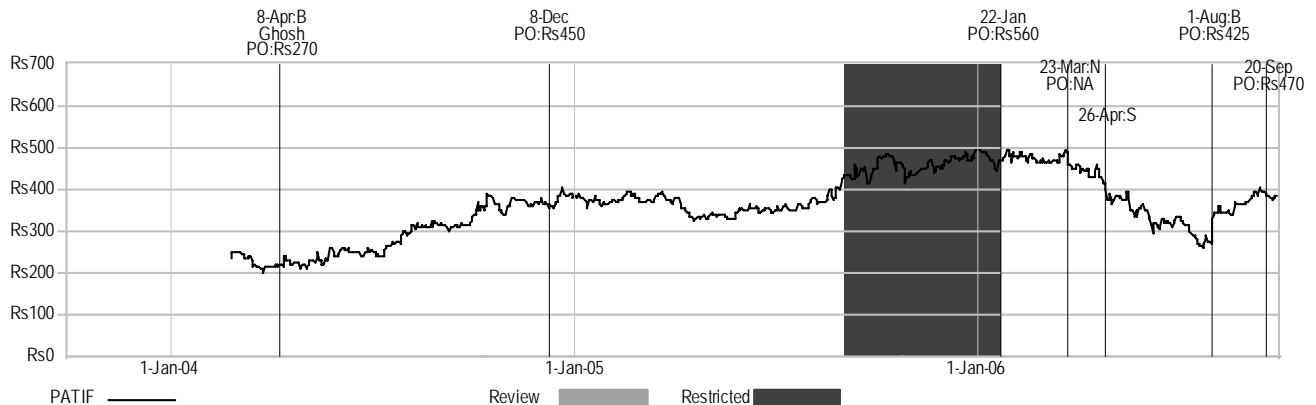
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Important Disclosures

PATIF Price Chart



B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of September 30, 2006 or such later date as indicated.

PTI Price Chart



B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of September 30, 2006 or such later date as indicated.

Investment Rating Distribution: Technology Group (as of 30 Sep 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	111	45.12%	Buy	21	18.92%
Neutral	126	51.22%	Neutral	21	16.67%
Sell	9	3.66%	Sell	1	11.11%

Investment Rating Distribution: Global Group (as of 30 Sep 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1325	44.76%	Buy	434	32.75%
Neutral	1420	47.97%	Neutral	412	29.01%
Sell	215	7.26%	Sell	48	22.33%

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