



## Satyam Computer

STOCK INFO.	BLOOMBERG
BSE Sensex: 12,709	SCS IN
	REUTERS CODE
S&P CNX: 3,677	SATY.BO

20 October 2006

Neutral

Previous Recommendation: Neutral

Rs428

Equity Shares (m)	653.5
52-Week Range	453/271
1,6,12 Rel. Perf. (%)	-3/-7/-14
M.Cap. (Rs b)	280.0
M.Cap. (US\$ b)	6.2

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	15.1	35.9	28.3	6.4	25.8	29.5	5.2	21.4
3/07E	65,784	13,820	21.1	39.5	20.3	5.1	28.2	30.8	3.7	15.9
3/08E	87,624	16,834	25.4	20.6	16.8	4.1	27.2	30.4	2.7	12.0

\* PAT figures reflects adjusted PAT, FY06 figures adjusted to reflect 1:1 bonus

- Revenue exceeds expectation, PAT higher due to lower taxes: Satyam reported revenue of Rs16b, up 11% QoQ, higher than our estimate of Rs15.8b. This was driven by volume growth of 9.5% QoQ and pricing improvement of 0.4% onsite and 0.2% offshore. EBITDA margins were down 200bp QoQ due to salary hikes.
- Pricing to hold steady in FY07, renewals at 3%-5% higher rates: Pricing is expected to remain steady, with around 3%-5% rate hikes in renewal contracts. Rates have been inching up slowly quarter on quarter due to the company's efforts in this direction. We expect pricing to inch up gradually since greater composition of large deals could result in muted price increases.
- Any significant margin improvement in 2HFY07 unlikely: Restricted stock unit (RSU) charges are estimated to impact margins by 110bp in 3QFY07. Likely rupee appreciation is also to impact margins by another 70bp. However the management expects to improve margins QoQ by leveraging utilization rates, offshore composition, improvement in subsidiary profitability and SG&A.
- We maintain Neutral: With robust employee addition in 2QFY07 as well as to factor in lower taxation, we have revised our EPS estimates upward by 4.3% for FY07 to Rs21.1 and 5.6% for FY08 to Rs25.4 (much of the upgrade is coming from lower tax rate). At CMP stock is trading at 20.3x FY07E and 16.8x FY08E, which we believe does not offer any major room for upside. We reiterate **Neutral** for a price target of Rs455 (upside of 6%). With lower head room for margin levers and higher business risk in terms of high concentration to US and package implementation, we believe that positive surprises will be higher in peers going forward.

### QUARTERLY PERFORMANCE

(Rs Million)

Y/E MARCH	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
<b>Revenues</b>	<b>10,587</b>	<b>11,550</b>	<b>12,653</b>	<b>13,136</b>	<b>14,429</b>	<b>16,019</b>	<b>17,163</b>	<b>18,173</b>	<b>47,926</b>	<b>65,784</b>
Q-o-Q Change (%)	9.0	9.1	9.6	3.8	9.8	11.0	7.1	5.9	36.1	37.3
Direct Expenses	6,391	6,779	7,374	7,500	8,316	9,827	10,560	11,087	28,044	39,790
Sales, General & Admin. Expenses	1,789	2,007	2,133	2,291	2,563	2,567	2,712	2,917	8,220	10,758
<b>Operating Profit</b>	<b>2,407</b>	<b>2,764</b>	<b>3,146</b>	<b>3,345</b>	<b>3,550</b>	<b>3,625</b>	<b>3,891</b>	<b>4,169</b>	<b>11,662</b>	<b>15,235</b>
Margins (%)	22.7	23.9	24.9	25.5	24.6	22.6	22.7	22.9	24.3	23.2
Other Income	234	316	330	289	745	282	387	453	1,168	1,867
Depreciation	313	347	341	372	362	375	429	454	1,373	1,620
Interest	5	8	27	17	26	27	34	36	55	123
<b>PBT bef. Extra-ordinary</b>	<b>2,323</b>	<b>2,725</b>	<b>3,108</b>	<b>3,246</b>	<b>3,908</b>	<b>3,505</b>	<b>3,815</b>	<b>4,132</b>	<b>11,402</b>	<b>15,359</b>
Provision for Tax	392	333	386	397	368	307	381	454	1,508	1,510
Rate (%)	16.9	12.2	12.4	12.2	9.4	8.8	10.0	11.0	13.2	9.8
Share of (P)/L in Associate Companies	29	19	24	2	0	0	0	0	73	0
Minority Interest	0	0	0	0	-1	0	10	19	0	28
<b>PAT bef. Extra-ordinary</b>	<b>1,902</b>	<b>2,373</b>	<b>2,697</b>	<b>2,847</b>	<b>3,541</b>	<b>3,198</b>	<b>3,423</b>	<b>3,658</b>	<b>9,820</b>	<b>13,820</b>
Q-o-Q Change (%)	-7.7	24.7	13.7	5.5	24.4	-9.7	7.0	6.9	38.0	40.7

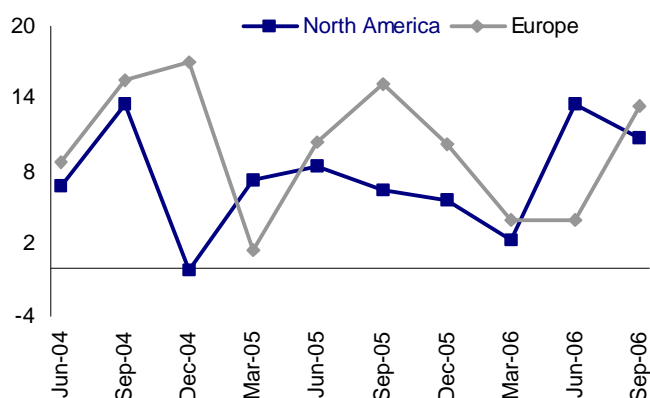
E: MOST Estimates

### Revenue exceeds expectation, PAT higher due to lower taxes

Satyam reported revenue of Rs16b, up 11%QoQ, higher than our estimate of Rs15.8b. This was driven by strong volume growth of 9.5% QoQ (our estimate: 9%) and pricing improvement of 0.4% onsite and 0.2% offshore.

Top clients excluding the GE group grew robustly during the quarter - top 2-5 grew 11%, top 6-10 grew 10.1% QoQ. GE grew slower at 4.4% QoQ. Engineering Solutions and Enterprise Consulting also grew strongly at 18.1% and 11.3% QoQ. Europe turned in strong performance with 13.5% QoQ growth.

#### STRONG REVENUE GROWTH FROM EUROPE



Source: Company/Motilal Oswal Securities

The company effected salary hikes of 18-19% for offshore and 5-6% for onsite during the quarter, which impacted margins by 420bp. Lower visa costs and rupee depreciation offset the negative impact of wage hikes by 120bp and 30bp, respectively. Improvement in subsidiary margins during the quarter also helped cushion margins by 30bp. EBITDA margins for the quarter were lower by 200bp at 22.6%, in line with our estimates.

Depreciation was lower during the quarter at 2.3% (our estimate: 2.7%). Other income was lower than expected at Rs282m (our estimate: Rs411m). Net profit was higher

than expected at Rs3.2b (our estimate: Rs3.06b) due to lower than expected tax rate at 8.8% on account of provision for deferred tax asset for leave encashment. Going forward Satyam expects tax rate of around 9.5-10% for FY07 against our earlier tax rate estimate of 13.1%.

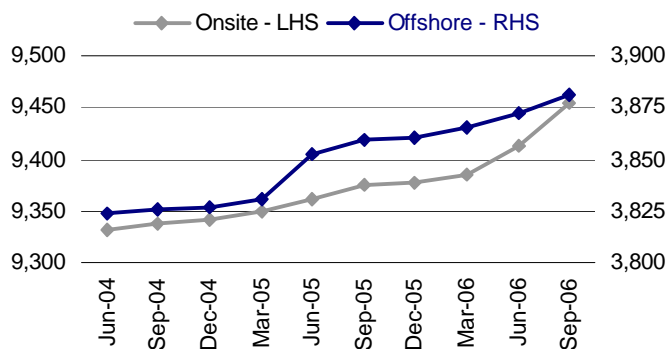
### Near term volume visibility remains good, however; Satyam vulnerable to US slow down

Satyam is witnessing greater offshoring of discretionary spending. In addition, the company is targeting greater proportion of revenue to come from large deals. The deal pipeline is very strong - 25 deals of which 12 are in the last stages of finalization. All these deals have contract value of US\$50-100m over a period of 3-7 years. Conversion of the pipeline into deal wins would add to pace of volume growth for the company in near term. Employee addition at a record high of 4,025 also indicates similar strength in volumes in the second half of FY07. Satyam also expects to add 13,000 gross employees against earlier guided 11,000-12,000 employees in FY07. However, with increasing contribution of Package Implementation, we believe that any significant slowdown in US economy in medium-long term could slowdown volume growth for Satyam Computers.

### Pricing to hold steady for FY07, renewals at 3-5% higher rates

Satyam expects pricing to remain steady for FY07, with around 3-5% rate hikes in renewal contracts. The company is currently renegotiating with all its top clients for rates under a competency-based pricing model. Rates have been inching up slowly quarter on quarter due to the company's efforts in this direction. We expect pricing to inch up gradually since greater composition of large deals could result in muted price increases. Satyam Computers is also witnessing 3-5% uptick in pricing for new contracts (lower than peers like TCS and Wipro who are expecting 5-10% uptick in new contract).

ONSITE/OFFSHORE BILLING RISING RATES (US\$/MONTH)

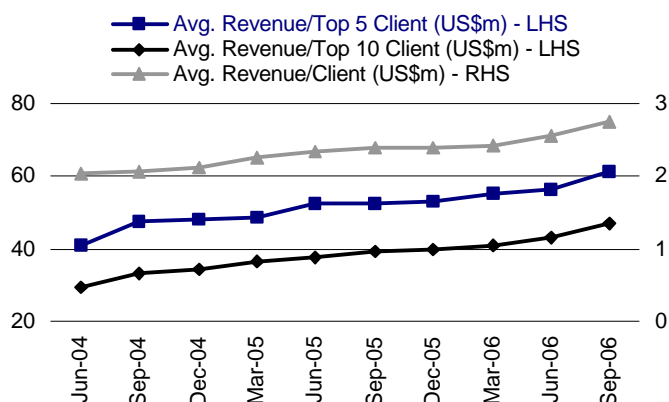


Source: Company/Motilal Oswal Securities

**Increased client mining resulted in better revenue per client**

Like peers, average revenue per client for Satyam have been improving steadily over the past few quarters due to greater client mining and extension of service offerings. However, unlike peers, where there was considerable improvement in terms of churning of clients to higher revenue brackets, for Satyam Computers number of clients with more than US\$10m revenues have gone down to 32 from 33 in 1QFY07 which Satyam explained as a quarterly aberration.

REVENUES/CLIENT HAVE BEEN RISING STEADILY



Source: Company/Motilal Oswal Securities

**Any significant margin improvement in 2HFY07 unlikely**

Satyam would be granting restricted stock units (RSU) to its key employees, the charge for which is estimated to

impact margins by 110bp in 3QFY07. The company expects that likely rupee appreciation would impact margins by another 70bp during the quarter.

Satyam Computers has guided for 4-4.5% growth in sales as well as EPS for 3QFY07. However it expects improvement in the margins in coming quarters despite introduction of RSU (impact of around 110bp) and likely rupee appreciation. The management expects saving from improving offshore contribution, higher utilisation rates, improving employee pyramid and further improvement in subsidiaries performance which will contribute to margin improvement in coming quarters. However considering utilisation rates as well fixed price contribution higher than peers, we believe any significant improvement in margins going forward is unlikely.

**Outlook and view**

Satyam has also revised its FY07 guidance upward by 3-4% for Sales to Rs6.45-6.48b (growth of 34.6-35.1% versus earlier growth of 29.2-31.2%). On the EPS front upward revision is 5.4-6.6% to Rs20.7-20.8 (growth of 35.9%-36.4% from earlier guided growth of 27.5-29.5%). With this, it also expects to add 13,000 gross employees against earlier guided 11,000-12,000 employees in FY07. Thus for 4QFY07 Satyam expects 4.5-5% growth in sales as well as in EPS.

With robust employee addition in 2QFY07 as well as to factor in lower taxation, we have revised our EPS estimates upward by 4.3% for FY07 to Rs21.1 and 5.6% for FY08 to Rs25.4 (much of the upgrade is coming from lower tax rate). At CMP stock is trading at 20.3x FY07E and 16.8x FY08E, which we believe does not offer any major room for upside. We reiterate **Neutral** for a price target of Rs455 (upside of 6%).

With lower headroom for margin levers in terms of offshoring, utilisation rates as well as improvement in fixed price contribution and higher business risk due to high concentration to US and package implementation, we believe that positive surprises will be higher in peers going forward.

## Satyam Computer: an investment profile

Satyam is the fourth largest Indian IT services company employing more than 31,000 people. It enjoys leadership position in the package implementation services segment and services over 500 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.
- ✍ Lower contribution from high growth Europe geography.
- ✍ Higher concentration towards package implementation revenues.

### Recent developments

- ✍ Won the American Society for Training and Development's 2006 BEST award
- ✍ Established training academy to double its pool of certified consultants on SAP® solutions.

### Valuation and view

- ✍ CAGR of 35.2% in sales and 30.9% in net profit over the next two years.
- ✍ Valuations at 16.8x FY08E do not offer room for major upside.
- ✍ Maintain **Neutral**.

### 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	20.3	19.1	19.5
	FY08E	16.8	15.9	16.5
P/BV (x)	FY07E	5.1	4.4	2.6
	FY08E	4.1	4.0	2.3
EV/Sales (x)	FY07E	3.7	2.8	1.9
	FY08E	2.7	2.1	1.4
EV/EBITDA (x)	FY07E	15.9	12.9	11.4
	FY08E	12.0	9.9	9.0

#### SHAREHOLDING PATTERN (%)

	JUN.06	MAR.06	JUN.05
Promoters	9.2	14.0	15.2
Domestic Institutions	12.0	7.4	5.4
FII's/FDIs	67.1	73.5	75.0
Others	11.7	5.1	4.4

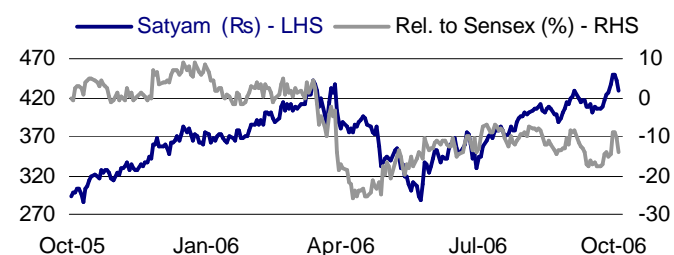
#### EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	21.1	20.0	5.4
FY08	25.4	24.0	5.8

#### TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
428	455	6.3	Neutral

#### STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT						RATIOS					
(Rs Million)											
Y/E MARCH	2005	2006	2007E	2008E	2009E	Y/E MARCH	2005	2006	2007E	2008E	2009E
<b>Sales</b>	<b>35,208</b>	<b>47,926</b>	<b>65,784</b>	<b>87,624</b>	<b>109,545</b>	<b>Basic (Rs)</b>					
Change (%)	37.5	36.1	37.3	33.2	25.0	<b>EPS</b>	<b>11.1</b>	<b>15.1</b>	<b>21.1</b>	<b>25.4</b>	<b>29.9</b>
Cost of Goods Sold	23,821	32,738	46,235	62,485	79,500	Cash EPS*	12.9	17.2	23.6	28.9	34.1
SG&A	2,705	3,526	4,313	5,766	7,063	Book Value	51.6	66.5	83.7	104.0	127.4
<b>EBITDA</b>	<b>8,682</b>	<b>11,662</b>	<b>15,235</b>	<b>19,372</b>	<b>22,982</b>	DPS	2.5	3.5	4.9	5.9	7.0
% of Net Sales	24.7	24.3	23.2	22.1	21.0	Payout %(Incl.Div.Taxes)	22.4	23.3	23.3	23.3	23.3
Depreciation	1,133	1,373	1,620	2,278	2,848	<b>Valuation (x)</b>					
Interest	9	55	123	175	55	P/E		28.3	20.3	16.8	14.3
Other Income	847	1,168	1,867	2,064	2,536	Cash P/E		24.8	18.2	14.8	12.5
<b>PBT</b>	<b>8,387</b>	<b>11,402</b>	<b>15,359</b>	<b>18,982</b>	<b>22,615</b>	EV/EBITDA		21.4	15.9	12.0	9.6
Tax	1,176	1,508	1,510	2,183	2,714	EV/Sales		5.2	3.7	2.7	2.0
Rate (%)	14.0	13.2	9.8	11.5	12.0	Price/Book Value		6.4	5.1	4.1	3.4
<b>PAT</b>	<b>7,116</b>	<b>9,820</b>	<b>13,820</b>	<b>16,834</b>	<b>19,969</b>	Dividend Yield (%)		0.8	1.1	1.4	1.6
Change (%)	37.0	38.0	40.7	21.8	18.6	<b>Profitability Ratios (%)</b>					
Extra Ordinary Items	0	1,598	0	0	0	RoE	23.9	25.8	28.2	27.2	25.9
<b>Net Income</b>	<b>7,116</b>	<b>11,418</b>	<b>13,820</b>	<b>16,834</b>	<b>19,969</b>	RoCE	28.1	29.5	30.8	30.4	29.3
<b>BALANCE SHEET</b>	<b>(Rs Million)</b>					<b>Turnover Ratios</b>					
Y/E MARCH	2005	2006	2007E	2008E	2009E	Debtors (Days)	81	75	72	72	72
Share Capital	639	649	1,310	1,323	1,336	Asset Turnover (x)	3.5	3.6	3.9	4.1	4.2
Preference share capital	910	910	910	910	910	<b>Leverage Ratio</b>					
Share Premium	8,917	10,292	11,095	12,783	14,429	Debt/Equity Ratio(x)	0.0	0.0	0.0	0.0	0.0
Other Reserves	22,515	31,322	41,464	53,821	68,481	<b>CASH FLOW STATEMENT</b>	<b>(Rs Million)</b>				
<b>Net Worth</b>	<b>32,981</b>	<b>43,173</b>	<b>54,778</b>	<b>68,837</b>	<b>85,156</b>	Y/E MARCH	2005	2006	2007E	2008E	2009E
Minority Interest	0	42	70	132	285	Cash Flow from Operations	7,350	10,128	13,308	16,945	20,081
Loans	189	1,027	1,186	1,000	1,000	Cash for Working Capital	-1,336	-2,605	-2,251	-3,104	-3,240
Deferred Tax	-107	-46	-463	-805	-1,212	<b>Net Operating CF</b>	<b>6,015</b>	<b>7,523</b>	<b>11,057</b>	<b>13,841</b>	<b>16,841</b>
<b>Capital Employed</b>	<b>33,063</b>	<b>44,195</b>	<b>55,571</b>	<b>69,164</b>	<b>85,229</b>	Net Purchase of FA	-1,854	-3,034	-3,198	-4,500	-5,000
Gross Block	10,142	13,172	16,672	21,172	26,172	Net Purchase of Invest.	1,797	2,584	1,867	2,064	2,536
Less : Depreciation	7,057	8,402	10,022	12,301	15,149	<b>Net Cash from Invest.</b>	<b>-57</b>	<b>-451</b>	<b>-1,330</b>	<b>-2,436</b>	<b>-2,464</b>
<b>Net Block</b>	<b>3,086</b>	<b>4,770</b>	<b>6,650</b>	<b>8,872</b>	<b>11,023</b>	Equity and related items	1,122	1,399	1,465	1,702	1,660
CWIP	693	803	500	500	500	Proceeds from LTB/STB	107	838	159	-186	0
Investments	763	0	0	0	0	Dividend Payments	-1,732	-1,893	-3,277	-4,126	-4,818
<b>Curr. Assets</b>	<b>32,900</b>	<b>45,752</b>	<b>57,513</b>	<b>73,560</b>	<b>88,509</b>	<b>Net CF from Finan.</b>	<b>-502</b>	<b>343</b>	<b>-1,652</b>	<b>-2,610</b>	<b>-3,158</b>
Debtors	7,805	11,684	15,350	20,660	24,359	Free Cash Flow	4,161	4,489	7,859	9,341	11,841
Cash & Bank Balance	23,701	31,117	39,192	47,986	59,206	<b>Net Cash Flow</b>	<b>5,455</b>	<b>7,416</b>	<b>8,075</b>	<b>8,794</b>	<b>11,220</b>
Loans & Advances	1,148	1,843	2,104	3,154	3,419	<b>Opening Cash Bal.</b>	<b>18,246</b>	<b>23,701</b>	<b>31,117</b>	<b>39,192</b>	<b>47,986</b>
Other Current Assets	247	1,108	868	1,761	1,525	Add: Net Cash	5,455	7,416	8,075	8,794	11,220
<b>Current Liab. &amp; Prov</b>	<b>4,379</b>	<b>7,130</b>	<b>9,092</b>	<b>13,768</b>	<b>14,803</b>	<b>Closing Cash Bal.</b>	<b>23,701</b>	<b>31,117</b>	<b>39,192</b>	<b>47,986</b>	<b>59,206</b>
Creditors	1,720	3,323	2,985	5,418	5,087						
Other Liabilities	763	1,047	1,058	1,746	1,759						
Provisions	1,896	2,760	5,049	6,604	7,957						
<b>Net Current Assets</b>	<b>28,522</b>	<b>38,622</b>	<b>48,421</b>	<b>59,793</b>	<b>73,706</b>						
<b>Application of Funds</b>	<b>33,063</b>	<b>44,195</b>	<b>55,571</b>	<b>69,164</b>	<b>85,229</b>						

E: MOST Estimates

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@motiloswal.com

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

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<b>Disclosure of Interest Statement</b>	<b>Satyam Computer</b>
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



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